Arthur Andersen
Professional Standards Group

To: Carl E. Bass@ANDERSEN WO
cc: Benjamin S. Neuhausen@ANDERSEN WO
Date: 12/18/99 09:31 AM
From: John E. Stewart, Chicago 33 W. Monroe, 50 / 72335
Subject: Re: Enron Option

Thanks for the memo. Very clear and I agree with your advice. Lets wait until Monday. The orginal accounting was probably aggressive even though it was consistent with our 1986 book. The book clearly says the that this accounting is for hedges of things carried at market. Otherwise, options are at real fair value. That book was written in another era and time has probably passed it by, but clearly after the stock was sold, one needs to revert to regular mark to fair value(both time and intrinsic value) and derivatives cannot hedge derivatives for accounting purposes—now or under FASB 133. Does Dave think his accounting works even under FASB 133? No way.

To: John E. Stewart@ANDERSEN WO
cc:
Date: 12/18/99 08:24 AM
From: Carl E. Bass, Houston, 237 / 2314
Subject: Enron Option

It may be easier to put this in writing. Dave Duncan called me after I left the Octel to you yesterday that he had already spoken to Mike Odom, the Houston office Practice Director and that they "made a practice call."

Background
About three weeks ago I got a call from Clint Carlin regarding a proposed Enron transaction to sell a marketable security that they are accounting for at fair value. They are not applying Statement 115 using the trading classification, rather they are applying fair value under investment company accounting. There are some options that they entered into with this SPE managed by the company's CFO. Initially they were going to sell the security and the options and the initial question was can the options be included. I said yes they fall under Statement 125 since they are financial assets. Clint came back and said that there was a problem because there was a difference between the carrying amount of the options and what they would receive. That is when I found that they had applied our guidance in Accounting for Options. That is they bifurcated the option between the time value and the intrinsic value and amortized the time value over 5-10 years, depending on the particular option. Our guidance clearly accepts this even for a fair value investment. So I told them that they needed to account for the difference (ie through P&L) when they sold the options and the stock compared to the proceeds received which presumably would be at fair value. I did not hear from them again until last Thursday.

They asked another question. During the course of the call I inquired about the options. I was told that the options were not included in the sale. I told them that if they sold the underlying and now had a naked option and would need to get its carrying value to fair value for the entire option (both intrinsic value and time value) and that the charge should go through P&L.

Dave Duncan called me yesterday and said that he had never understood the bifurcation approach in our book to be hedge accounting. Rather he believed it was just another way to account for fair value. So in his mind he had two instrument that were being accounted for at fair value. I told him that hedge accounting was the only way to get that bifurcated approach and once the hedged item was sold, there was some accounting to do. I told him that we do not accept hedge accounting for a derivative by another derivative (as part of the Statement 125 transaction they apparently took back a total return swap) and in any event it would be inappropriate to carry forward a hedge on one asset (the marketable security) to another instrument (the total return swap). He told me that the charge here would be $30-50 million. He said that the deal had either been signed or was about to be signed and that we could not go back now. I stated that our advice was consistent and timely on this. He said that he was not clear that the original bifurcated approach he had discussed with was limited to hedging despite the language in our book, which I pointed out to him.

I also spoke with Ben to see if there was anything else Ben could think of to help them out and Ben had no other thoughts.

<u>My concerns</u>
We raised the issue. I have not spoken to the Practice Director. I do not know if he knows how much we cannot support this. Where do we go from here? This is a big item and the team apparently does not want to go back to the client on this. I think at a minimum the Practice Director needs to be made aware of this history and our opposition to the accounting. I guess this call onMonday os to see if there is some way we can find that can accept this but I am out of ideas.

I you want to talk about this today let me know. Otherwise it can wait till Monday. The deal has been done apparently.

John E. Stewart

Arthur Andersen
Energy

To: Carl E. Bass@ANDERSEN WO
cc: John E. Stewart@ANDERSEN WO, Benjamin S. Neuhausen@ANDERSEN WO, Patricia S. Grutzmacher@ANDERSEN WO
Date: 02/01/2000 06:19 PM
From: Debra A. Cash, Houston, 237 / 2344
Subject: Re: Enron transaction

With respect to whether the derivatives are at fair value, we will be getting a fairness opinion on the whole transaction. We would also require third party evidence of whether each derivative(the puts on the communication stock) would be at fair value at the time they are entered into.

With respect to the initial capitalization, Enron believes that the value of the puts day one (the put premium) represents the risk of the instrument for the period that it is outstanding. However, there is no similar model if the derivative is a swap. They recommend 3% of value at risk or some other probabilistic model.

Enron has currently agreed that they cannot account for the upside on ENE stock (in Carl's note 5) as P/L. They agreed that it is an equity transaction.

Our biggest issues are:

1. What does the initial capitalization of the spe have to be for Newco to be a substantive entity? (notional value or risk adjusted method)

2. What is the limitation on the MTM of the derivative (put)? Our proposal is that ENE cannot recognize income in excess of the initial capitalization of the spe plus the put premium. Under this method we would avoid recognizing income , although indirectly, on the appreciation of ENE stock.

To: Debra A. Cash@ANDERSEN WO
cc:
Date: 02/01/2000 04:10 PM
From: Carl E. Bass, Houston, 237 / 2314
Subject: Enron transaction

---------------------- Forwarded by Carl E. Bass on 02/01/2000 04:18 PM ----------------------

To: John E. Stewart@ANDERSEN WO, Benjamin S. Neuhausen@ANDERSEN WO
cc:
Date: 02/01/2000 02:31 PM
From: Carl E. Bass, Houston, 237 / 2314
Subject: Enron transaction

I would like to get your thoughts on this complicated series of Enron derivatives. Ben – Deb Cash said she has already spoken to you about another variation of this transaction. I suspect I will not be the final answer here either. Enron wants to make some investments in some entities that will have high volatility. They also want to do this through an investment company.

1. LJM (SPE) forms a NEWCO and capitalizes NEWCO with 100% equity.
2. Enron's investment company (ENE Sub) purchases an investment in a third party (Third Party) and pays $100,
3. ENE Sub purchases a put option from NEWCO (assume fair value is $40). The terms of the put option are that if the value of the investment in Third Party declines below $100, NEWCO wil pay ENE Sub the shortfall. If the value rises above $100, ENE will keep the upside. The $40 premium will pay for NEWCO taking on that risk. The terms are that ENE Sub will not pay the $40 immediately, nor will NEWCO cash settle the option till the end of the option period (say 5 years).
4. Enron at the same time enters into a share settled derivative on Enron stock with NEWCO. If Enron stock price increases, Enron pays NEWCO Enron shares. If Enron stock price decreases, Enron receives Enron shares.
5. Because Enron believes that Enron stock price is going to increases in value more than Third Party value, Enron caps NEWCO's return on this arrangement as follows. If NEWCO's return achieves 25% on both the Enron stock and the put option, Enron receives from NEWCO any income that was generated off of the combined investments.
6. NEWCO is a bankrupt proof entity.

Accounting Considerations

1. I believe the initial capitalization of NEWCO should be $1.8 (3% of their total exposure defined as $100 less the $40 premium). In another structure they did last year they computed the 3% as 3% of the premium (in this case $1.2). I do not think that this really covers the total risk exposure. If they did an at the money swap I told them that it should be 3% of the total exposure, that is $100 because that is what they are exposed to. The engagement team tells me that the client has pushed back on this. I gave them the operating lease analogy. *What does a swap do to the argument that you are an investment company wanting capital appreciation and you swap all of the upside away?*
2. Once you get past that, I believe Enron would mark to market the investment in Third Party using their investment company accounting model (you could treat this as a trading security under Statment 115 and get the same answer, assuming the investment was publicly traded and Enron did not have significant influence).
3. Enron would account for the put option at fair value (both time value and intrinsic value). See below however of my concern over the substance here.
4. Absent item 5 above, the share settled derivative in Enron stock should be an equity transaction pursuant to EITF 96-13. So the fair value ofthe derivative would be recorded at the date of issuance and there would no MTM changes in subsequent periods. But you have to ask yourself why is this here. Assuming the put option is truly at fair value, NEWCO should be receiving value in the form of a premium for this transaction. The equity derivative is unneccessary. If the Third Party investment is public, it should be fairly easy to calculate the premium value to make sure that it is at "fair value." If Third Party is not public, then I think you need to get a third party quote to provide for evidence of the internal valuation. Otherwise, this equity-settled derivative does not feel right. Does Enron mark to market Item 5 above? I think you have to be careful here because you can end up recording to income return on your own stock because of the nature of how this works.

5. Example of how this could work using the assumtions above. Assume that the $40 premium's time value amortization is $20 in year 1, $10 in year 2, $$5 in years 3 and 4, respectively. Assume that the value of the Third Party stock is $90 year 1, $80 year 2, $100 year 3, $130 Year 4, and $140 year 5. Added assumtion is that Enron stock increases $6 each year.

Calculation of Enron's accounting before the contingent obligation:

Year Cum	1	2	3	4	5
Premium (40)	(20)	(10)	(5)	(5)	0
Intrinsic value change	10	10	n/a	n/a	n/a
MTM Third Party Investment	(10)	(10)	20	20	20
Enron income effect	(20)	(10)	15	15	20

Calculation of income for NEWCO

Interest on premium (assume 5%) 8	2	2	2	2	2
MTM premium 40	20	10	5	5	0
Derivative on third party equity (20)	(10)	(10)	0	0	0
Enron equity derivative 30	6	6	6	6	6
Total 58	18	8	13	13	8

Under the terms of the contingent obligation, NEWCO needs $2.25 to achieve a 25% return. Enron would receive the excess, or $55.75. Enron believe they should recognize income of $55.75 on a MTM basis over the life of which $30 is their own stock, $40 is round trip of the option premium and $8 is round trip of interest expense. You can play around with these numbers a number of different scanarios, but at the end of the day, this contingent obligation will be due Enon stock. So I would conclude that there should be no MTM on the contingent obligation and no income on its settlement for the reasons cited above.

Going back to the Enron income effect, this whole deal looks like there is no substance. The only money at risk here is $1.8 million in a bankrupt proof SPE. Al of the money here appears to be provided by Enron. So in my year 1 example where Enron receives $10 in intrinsic value from the SPE with regard to the put option, I do not think they should record an amount greater than the SPE equity of $1.8.

John E. Stewart

Arthur Andersen
Professional Standards Group

To: Carl E. Bass@ANDERSEN WO
cc: James F. Green@ANDERSEN WO
Date: 02/04/2000 07:45 AM
From: John E. Stewart, Chicago 33 W. Monroe, 50 / 72335
Subject: Re: Enron Derivative Transaction

I think what you are saying is that the SPE needs to be consolidated. Thus, Enron stock is treasury stock(thus not gain or loss on that) and we have a small derivative on the internet stock that protects only for $3. We should discuss it some more. You have some good points. I suggest you send this memo to Deb, Tom and Dave to reintiate the discussion.

To: John E. Stewart@ANDERSEN WO, James F. Green@ANDERSEN WO
cc:
Date: 02/04/2000 06:38 AM
From: Carl E. Bass, Houston, 237 / 2314
Subject: Enron Derivative Transaction

I am still bothered with the is transaction we discussed yesterday. My understanding of the new structure is that Enron will purchase a derivative from SPE and the purchase price will be Enron stock. Assume that the value of that is $20 and the stock price of Enron stock is $2/share so Enron issues 10 shares. Presumably since they are paying an amount it is a premium for an option. In exchange, Enron will receive payments based on changes in the share price of two securities -- (1) an investment made by Enron in an internet stock ("Internet Co.") and (2) the Enron shares given to the SPE. Assume that initial investment in Internet Co. is $100. The payment is based on a formula, that is, if the SPE earns a 25% return on its initial investment, Enron receives all of the amount in excess of the return of and on the initial investment. If the return is less than 25%, the SPE keeps both its initial investment and any return up to 25%. In addition, because the SPE is also providing "protection" to Enron for Enron's investment in Internet Co., the SPE may have to give up its entire initial equity to pay Enron in the event the value of the investment in Internet Co. declines. Assume that the equity holders in the SPE put in 3% of the notional value of the Internet Co., or $3. The SPE is initially capitalized with only $3 (no debt, all equity) and it receives from Enron Enron shares valued at $20.

The initial entry made by Enron for this derivative has to be as follows:

Option	20	
Capital		20

I am bothered by two things. One, if we mark to market the receive leg of this entry, then are we not marking to market through earnings the change in value of that initial equity transaction. If the above was a share settled derivative we would have made the exact same entry and not marked to market the transaction subsequent to the initial transaction. If we mark to market, then we are receiving the appreciation on the shares we gave up.

Second, I believe this SPE is nonsubstantive. This entity is capitalized with all equity and that equity is only 3% of the ~~notional~~ amount of the risk it is providing protection for? Not to worry, because it now has these Enron shares that will increase in value. If the Internet Co. stock fails and Enron share value increases, SPE pays Enron for the Internet Co. risk from appreciation on Enron shares. I stock rises and Enron share value increases, SPE pays Enron based on appreciation in ' Internet Co. stock falls and Enron share value falls, SPE pays Enron $3. I do not see w/ (particularly this SPE) has any substance.

QUESTION NO. 3

What is meant in the consensus by the term EXPECTED SUBSTANTIVE RESIDUAL RISKS? Does it mean the 90 percent threshold specified in paragraph 7(d) of Statement 13?

What amount qualifies as a substantive residual equity capital investment (condition (3) of the consensus)?

RESPONSE

In these transactions, the significant elements of management and control over the leased asset generally are specified by contract when the lease is negotiated and the SPE is established. Certain of these elements of management and control raise concerns on the part of the SEC staff with respect to who possesses the risks and rewards of ownership of the leased asset. These include elements such a nonsubstantive lessor without equity at risk, a lessee who has the ability to realize all appreciation and bears substantial risk of depreciation, and a lessee who act as the construction agent and selling agent and who is at more than nominal risk. In determining if a registrant has substantive residual risks and rewards of the leased asset (condition (2) of the consensus), the SEC staff would review a transaction to determine if the lessee has these or similar elements of management and control. If the lessee would reasonably be expected to bear the substantive residual risks and receive rewards due to such elements, the SEC staff would consider condition (2) to be met. This would be a judgmental decision based on the specific facts and circumstances of each transaction, and does not involve the 90 percent determination as set forth in Statement 13.

The initial substantive residual equity investment should be comparable to that expected for a substantive business involved in similar leasing transactions with similar risks and rewards. The SEC staff understands from discussions with Working Group members that those members believe that 3 percent is the minimum acceptable investment. The SEC staff believes a greater investment may be necessary depending on the facts and circumstances, including the credit risk associated with the lessee and the market risk factors associated with the leased property. For example, the cost of borrowed funds for the transaction might be indicative of the risk associated with the transaction and whether an equity investment greater than 3 percent is needed.

As the consensus states, the investment should be at risk with respect to the leased asset for the entire term of the lease. The investment would not be considered to be at risk, for example, if the investor were provided a letter of credit or other form of guarantee on the initial investment or return thereon. An investor note payable issued to the SPE would not qualify as an initial substantive residual equity investment at risk.

I have to ask myself why not do straight deal with Goldman? They said so themselves, it would be too expensive. If they want appreciation in their own shares, why not do an equity derivative (cash settled)? Don't want the volatility. Why is the SPE not capitalized with 97% debt? Because no bank is dumb enough to loan money whose repayment is dependent on changes in value of an internet stock. By the way, if they did so and Enron guaranteed the debt I would have the same issues.

So I think the accounting for this is as follows:

1. The SPE is non substantive. They receive no protection on the option, other than $3.
2. Any payments made on the appreciation of stock is in essence an equity transaction. They should realize no income on this. It looks like they have parked the shares there because they get it back one way or another.

John E. Stewart

CARL

OO-19 called FA stuff

Prepaid renegotiate

Deb
Rick
CARL

called STC stuff

Echols ($ WILLARD)
CARL
TOO TECHNICAL
CLIENT SATISFACTION
INVOLVED w BLOCK
BOSTON

Arthur Andersen
PROFESSIONAL STANDARDS GROUP

To: John E. Stewart@ANDERSEN WO
cc:
Date: 03/04/2001 06:46 PM
From: Carl E. Bass, Houston, 237 / 2314
Subject: Enron

I know you did not ask for this but I believe you should be at least have a version of what I know about this Enron "thing" from me. You may share this with anyone you deem appropriate -- we are after all partners in this Firm and should be able to have an open dialogue about issues, especially those that affect partners. In addition, it appears that I have been the subject of some conversation and no one has discussed this with me directly. So treat this as my own New York Times OpEd piece, expect we are not discussing Presidential pardons.

<u>The Enron "thing" with me</u>
With regard to this "thing," I believe that several points need to be made. There appears to be some sort of assertion that I have a "problem" with Rick Causey or someone at Enron that results in me having some caustic and inappropriate slant in dealing with their questions. You may recall that when I joined the PSG on December 1, 1999, Dave Duncan had requested 500-750 hours of my time on Enron specific consultation. At the time, I/we was/were told that this was cleared with the client. If in fact I had some sort of "problem," one would have though that would have surfaced at that time. The client would have vetoed such an arrangement. In fact, I was told this was sold to them. Logic would also seem to dictate that if there was some sort of "problem," I would have been removed as one of the engagement partners, much less been placed on it to begin with. Believe me, if I had some "problem," I would have never requested to have been put on the engagement given the complexity and challenges that that engagement entails. So any notion that there is some sort of long, deep seeded animosity needs to be dispelled as it simply is not true -- nor do the facts warrant it. I should also note that I have gone to great lengths to get Causey in front of standard setters. For example, I was able to get Causey to be a guest at the EITF meeting when tolling agreements were discussed because they had a vested interest in the accounting for those transactions. If I had some sort of ax to grind, I would not have even orchestrated that.

With regard to the yearend issues that apparently triggered this "thing with me," lets go through them one by one. Again, there was dialogue on process here that I was not party to but apparently I have some sort of "problem" here.

1. Blockbuster transaction -- Roger Willard and Clint Carlin approached me for about 15 minutes one afternoon to discuss two things. One, whether an interest in joint venture could be securitized and two, what are the requirements to be a joint venture. With respect to the first question, I said yes as long as it is accounted for on the equity method. We then discussed the requirements of a joint venture, including the fact that it had to be a business. The original Blockbuster transaction was simply where Enron was going to contribute this contract and the other party was going to contribute systems and expertise to deliver this product to households. I received one other question from Clint Carlin, dealing with some puts and calls. About two months later Roger Willard asked whether the equity needed to be 3% of fair value or book value. At that time I was told that they were going to have some $50 million gain on the sale of this venture interest immediately after the contract was signed and the venture was entered into. Furthermore, the other venture partner was not contributing anything. At that time, both you and I had expressed some concern about this deal. It should be noted that despite all of the turmoil over this, we (PSG) did not object to this transaction as it appeared to meet the technical requirements of Statement 125. We relied on the engagement team to address both the definition of a business and the valuation issues of immediate gain. The client's proposed accounting nonetheless was sustained. At that time, I

was aware of another securitization in which the client had provided a side agreement to guarantee the 3% residual equity at risk with the same counterparty in this transaction. Although it is not my job (which I acknowledged to the engagement team), I did suggest confirmation as an audit procedure. I believe knowledge of this did prompt us over a weekend to have the engagement team involve various levels of practice directors in this decision. In effect, this was a very risky transaction and we did not believe that the PSG should solely be in on this without others.

With respect to the infamous 4:1 test, they did not follow our advice on this. I did acknowledge several times with the engagement team that although our test is grounded in GAAP, we did make it up and it is no where to be found in the accounting literature.

2. Networks transaction -- Tom Bauer involved me on this transaction. It was similar to the one above but did involve the sale of an existing Enron business through a securitization transaction. This was probably the nth step of a series of permutations of this transaction that I had been involved in since November. The only late issue on this came after the deal had been signed. This was one of those deals where Enron contributed a business worth $100. A bank contributed cash totaling $100. The bank did this through an SPE whereby the residual equity holder contributed $3 and the debt holder contributed $97. I was asked after the deal had been signed whether that was OK. We had discussed this issue a lot within the PSG and had in fact had a client issue with the SEC along these lines. In addition, we had discussed this issue with the Enron engagement team last summer in which they documented the conclusion that the equity person would have had to contribute $6. I understand now that the gain on that transaction was $100 million. In addition, other Enron transactions had been capitalized as we have suggested.

The engagement team went back and had the equity holder contribute additional equity. The equity holder in this case was the LJM entity, a related party because the CFO is the managing equity member.

3. "Raptor" derivative transactions -- Enron has entered into a series of complicated derivatives with a related party (the CFO) in which this related party CFO writes options to Enron to protect Enron's investments in various internet businesses. The capital for the SPE is derived from Enron cash settled derivatives that are European in that they cash settle at the end of the derivative life. I will honestly admit that I have a jaded view of these transactions and "dragged my feet" initially. This was in part due to an impairment test that Deb Cash had devised to keep these transactions honest. The yearend issues dealt with the impairment test. The engagement team had asked whether these various SPEs could be cross collateralized so that losses in one entity could offset losses in another. I told them that as long as they were truly cross collateralized that seemed OK. The problem I was told was that the CFO had no reason to inject a loss on one vehicle. The client's proposal was that the vehicles be cross collateralized but if the there was a loss in one vehicle, the CFO had the option to remove the cross collateralization any time he chose to. Based on how the impairment test was devised, I did not see any way that this worked. In effect, it was heads I win, tails you lose. The engagement team appeared to be split on this -- two partners had a problem with the client's proposed accounting and one did not. In the end, however, the engagement team agreed with me as did the Practice Director. It was decided by them to "fix" this feature before the release of the financial statements. One thing to note was I was told that the client never agreed to the impairment test to begin with. So the real issue that I thought had been addressed and resolved had never been resolved with the client.

One problem I had with Raptor was that the original structure was one in which the PSG was not consulted on. In that transaction, the SPE had at risk only a nominal amount of equity (less than the 3% residual at risk of the notional value of an internet investment). Furthermore the SPE was in a bankrupt entity so any loss on the derivative could not be funded by the SPE. I understood that there was a $100 million loss on an internet investment that otherwise should have been reported absent the derivative. At no time was PSG consulted on the original structure -- we did attempt to make sure the subsequent structures were adequately capitalized.

Those are the yearend issues. In total they represent about $150 million plus of income or avoided losses at yearend -- and all involved the Practice Director. At no time did I ever have communication with the client on these issues. All of my communications were solely with the engagement team. You can understand then as to how I am perplexed as to how the client even knows I was consulted on with respect to these issues and how they believe I am too caustic and cynical with respect to their transactions (see below).

The only other issue that came up post yearend but affected 2000 was the Azurix impairment. I was consulted on an impairment issue at the Azurix level. I told the engagement team that their facts were a little shaky but if they could prove them then they had a position. It was not, however, without risk. At the time, Azurix was going through a "going private" transaction. The client wanted to record an impairment in the fourth quarter. I was also consulted on the impairment issue at the Enron level of its investment in Azurix. You had told them about 6-9 moths ago that 6-9 months was a good indicator of whether an impairment was permanent with respect to that investment. I had repeated that advice post yearend but by then the investment was under water for about 18 months. I told the engagement partner that it was judgment -- not really PSG's call. I was told by him that "he had never communicated the original advice to the client and therefore he could not go in and do so now." I was led to believe that he went to his Practice Director. Again, not really our call.

Process

Apparently, part of the process issue stems from the client knowing all that goes on within our walls on our discussions with respect to their issues. I believe that when we are either having discussions or have reached a decision, the FIRM has done so. The PSG only gives advice. The engagement partners and practice directors then reach a decision based on that advice as well as other considerations, but it is the FIRM that does so. We should not be communicating with the client that so and so said this and I could not get this past so and so in the PSG. I learned that lesson the hard way when I was senior working for Gary Goolsby about 17 years ago. I have first hand experience on this because at a recent EITF meeting some lower level Enron employee who was with some else from Enron introduced herself to me by saying she had heard my name alot -- "so you are the one that will not let us do something." I have been on calls where the EA has interrupted the call saying that so and so was waiting for an answer from me on this that or the other. In fact, the client called during a meeting on the Raptor derivative transactions between me, the Practice Director, and the engagement team. One of the partners told the EA that interrupted us that "they were still meeting with Carl."

I have also noted a trend on this engagement that the question is usually couched along the lines "will the PSG support this?" When a call starts out that way, it is my experience that the partner is struggling with the question and what the client wants to do. But lately managers have been posing their questions that way.

Let me propose an alternative. The engagement team should prepare a memo documenting all aspects of the transaction as well as the research that supports a conclusion or the conflicting research that leads to the grayness. All too often (in fact, without exception), it has lately been a call from a manager with a flowchart and we then have to slug through it to find the real issues. For example, within the past week the client proposed placing a contract into a "joint venture." An interest in the joint venture would then be sold for a $20-40 million gain. The parties to the joint venture were the same parties to the contract. There were no customers (the customer was the other "venturer"), no process, no business. In fact the press release was clear that a contract was entered into. There is no mention of a joint venture. In effect, nothing was accomplished in this transaction except a sale of future revenues. The engagement partner agreed with my view and in fact had the same view. She was seeking concurrence. I was told they booked the transaction any way and that we will propose a PAJE.

Once we conclude on something, or render some advice, the engagement team should deliver that advice or conclusion as if it was their own. It is after all the engagement team's responsibility to sign the opinion -- not ours.

DUNCAN 3/12/01

CARL

— NOT DUNCAN DRIVEN

SOME PUSH CARL OUT of engagement team
by client to set

— CAUSEY

— ECHOLS — STRONG FEELINGS

NEGATIVE VIEW of CARL

— CONSISTENCY of ADVICE

— THE FURTHER AWAY, more [illegible]

WIN/WIN TO GO TO PSG

CARL NOT MUCH INTERACTION directly WITH CLIENT

DISAPPOINTMENT (MATTERS IN THEORY VS. TRANSACTIONS)

Y-E ISSUE/LAST 6 MONTHS ⟹ CAME TO HEAD

CAUSEY = LOST political capital internally

LONDON problems

AAHEC(2)03453.1

need more leverage in Houston
on engagement team

TOM BAKER - 3 million [illegible] fees

JFS - NTT, DG

CLIENT SEFS need to replace carl /

CARL - move to CHICAGO
good solution,
But doesn't want to
come

PULL / PUSH

TIM JR too young

Documentation - weakest point

professional
process
personal

I WHY

II P, P, P — CONCLUSIONS

III WAY FORWARD

CHICAGO / HOUSTON

✓ 1. FILTER — CARL IN TRANSITION

✓ 2. writing — NOT TERM SAFE
— AWAY

✓ 3. TALKING
— DUNCAN
— ANONYMOUS
— NO MEETINGS
— BRAIN STORMING

✓ 4. NO GRAD ⇒ NEED MODEL

— consumer ptv
new ingredient ptvs

Andersen
ENERGY

To: John E. Stewart@ANDERSEN WO, Benjamin S. Neuhausen@ANDERSEN WO, Richard R. Petersen@ANDERSEN WO, Carl E. Bass@ANDERSEN WO, Jeffrey H. Ellis@ANDERSEN WO, Debra A. Cash@ANDERSEN WO, Patricia S. Grutzmacher@ANDERSEN WO, Roy Pineci@ANDERSEN WO, Richard Corgel@ANDERSEN WO
cc: Michael C. Odom@ANDERSEN WO
Date: 05/03/2001 04:08 PM
From: David B. Duncan, Houston, 237 / 2518
Subject: Enron Practice Review Request

One of the requests of the internal practice review team for Enron last summer was to confirm PSG consultation on certain selected transactions. For a variety of reasons,but mainly my own lack of proactiveness, this step has not been completed and is necessary for the review team to accomplish final sign-off of their work.
John and I discussed this some months ago and decided an outline that could facilitate a brief discussion would probably be more efficient than slogging through a number of memos and the practice review team has concurred. Attached is such an outline.

I will have my assistant, Shannon Adlong, work to set up what I hope will be brief calls to accomplish this task over the next couple of days/weeks. The topics and the suggested participants are listed below. Obviously, if we can kill multiple topics in any one call or with the fewest participants, that would be preferable(for instance, it looks like we could hit all the topics with a call to Ben and another to Carl or John, although I certainly don't want to preclude anyone's participation). The primary Enron team participant (me or Deb) will lead the discussion to walk through the key decisions and ,of course, we will want to respond to any questions from the review team.

Let me know of any suggestions or issues with this. Otherwise,thanks in advance for your help.

Transaction	Primary Enron	Primary PSG
Condor	Duncan	Ellis,Neuhausen
Nahanni	Cash	Neuhausen
EES Bundled K's	Cash	Stewart,Petersen,Bass
LJM	Duncan,Cash	Stewart,Bass

(As Patty Grutzmacher seemed to be involved in all these deals, she will also participate on the calls.)

transactionmemosummar

John E. Stewart

Transaction Name: Condor
Date:
Primary PSG Contact: Jeff Ellis
Other PSG Members Consulted: John Stewart and Ben Neuhausen
AA Individuals: Dave Duncan, Deb Cash, Patty Grutzmacher and Kate Agnew

Issue 1:
Should Enron consolidate White Wing?

Resolution:
Since,
- the third party investor had various significant participating rights,
- the third party investor was capitalized with equity based on the capital-at-risk of White Wing as opposed to the capital-at-risk of Osprey and
- White Wing met the majority of the joint venture attributes outlined in APB 18,

we decided that White Wing was appropriately considered a joint venture. As such, the capital-at-risk in the venture structure should be subjected to the 80/20 test we often apply to ensure that both parties in a deconsolidated joint venture have enough capital-at-risk to support the shared control characteristics of the venture.

Also since,
- the venture was being structured by Enron,
- the venture involved financial counterparties and significant financial assets, and
- it was contemplated that the venture would do a substantial amount of business with Enron,

we also determined that the venture should meet the 3rd party equity requirements of an SPE

In summary since,
- the third party investor had 1) significant participating rights, which included the ability to remove Enron as the Managing Member with or without cause and shared voting control,
- Enron did not have > 80% of the capital-at-risk of the joint venture and
- the 3rd party residual equity was calculated based on 3% of the capital-at-risk of the joint venture

we decided that Enron should not consolidate White Wing.

Issue 2:
Should Osprey's total contribution of $1.4 billion represent third party equity at risk in the 80/20 test?

Resolution:
As long as:
- The share settlement agreement was an asset of the joint venture,
- The share settlement agreement goes through the liquidation waterfall like all other joint venture assets,
- The partners had normal liquidation rights with no subjective acceleration and no attachment to any specific assets within White Wing (no direct collateralization),
- Indemnifications were only on negative capital (i.e., Enron cannot provide indemnifications on Osprey's initial investment)
- Any Enron indemnifications were for pre-existing conditions or were under normal operating agreements and
- Indemnifications on assets purchased from Enron by the venture go into an asset by asset risk/reward transfer test for purposes of determining if sale treatment was appropriate

then the total contribution made by Osprey should represent third party equity at risk in the 80/20 test.

Issue 3:
Can Enron recognize gains on the sale of assets to White Wing?

Resolution:
Gains/losses on sales to a joint venture with disproportionate sharing ratios were based on the "incremental hypothetical liquidation basis" (i.e., while White Wing was in the first payout where Enron received the first $750 million of gain/loss, Enron will be required to defer 100% of all gains and recognize 100% of all losses on sales of assets to White Wing).

Trasnsaction Name:	Nahanni
Date:	4th Quarter '99
Primary PSG Contact:	Ben Neuhausen
Other PSG Members Consulted:	None
AA Individuals:	Deb Cash and Patty Grutzmacher

Issue 1:
Can the exchange of Treasury Bills for the minority interest of the LP be considered a non-cash activity by Enron and only be disclosed in the footnotes (related literature SFAS No. 95 paragraph 32 and 70)?

Resolution:
Yes, as long as the Treasury Bills have a maturity longer than 90 days, the transaction would be non-cash and only require footnote disclosure.

Issue 2:
Can Treasury Bills be considered Merchant Investments?

Resolution:
Yes, the Treasury Bills can be considered Merchant Investments; however, Enron's Merchant Activities footnote should be changed to include government securities in the description of Merchant Investments.

Issue 3:
Does the issuance of minority interest require MIPS treatment?

Resolution:
No, because the minority interest holder's return was not fixed or guaranteed.

Transaction Name:	EES Bundled Contracts
Date:	October 27, 1999
Primary PSG Contact:	John Stewart
Other PSG Members Consulted:	Rick Petersen and Carl Bass
AA Individuals:	Deb Cash and Michael Patrick

Issue 1:
How should EES account for its energy trading activities when bundled with other services in one contract?

Resolution:
Bifurcate the components and account for using applicable guidelines (e.g. SOP 97-2, SOP 81-1, SFAS 133, SFAS 13, EITF 98-10, SFAS 125)

Issue 2:
How should EES separate the different service components of the contract if bifurcation is appropriate?

Resolution:
- Allocate revenue to non-trading activities based on objective verifiable evidence of fair value
- Remainder of revenue allocated to trading (which bears any "discount")

Issue 3:
How should EES account for subsequent changes in the estimated or actual volumes to be delivered under the bundled contract?

Resolution:
Captured in trading activity and MTM.

Issue 4:
How should EES account for subsequent changes in the cost of energy asset management projects?

Resolution:
Recognized as income or loss as the project was performed (i.e. accrual)

Transaction Name:	LJMI
Date:	2nd Qtr '99
Primary PSG Contact:	
Other PSG Participants:	
AA Individuals:	Dave Duncan Patty Grutzmacher

Issue 1
Is LJM an SPE?

Resolution
Since,
- The managing member was an Enron related party who was a senior officer of Enron and
- LJM's near-term objectives as far as we could observe, included investing in mainly Enron related assets

then LJM should be considered an SPE and reviewed for appropriate capitalization and control criteria as such.

Issue 2
Was the minimum capitalization and control requirements met in LJM to support deconsolidation by Enron?

Resolution
Yes, LJM was capitalized with 19% third party equity (excluding the Managing Members capital) which exceeded the required 3%. The managing member does not control LJM because the Limited Partners had various participating rights in investment decisions including the direct approval of any transactions contemplated with Enron (AALLP audited the LP's approval of the one and only transaction done by LJMI before it was liquidated).

Issue 3

Was the transaction between Enron and LJM arms length?

Resolution

Due to the relationship the General Partner of LJM has with Enron, AALLP requested an independent fairness opinion on each transaction executed between LJM and Enron that cannot be objectively valued otherwise. Also, all transactions with LJM would require related party disclosure as long as the CFO relationship exists.

Transaction Name:	LJMII
Date:	4th Quarter 99
Primary PSG Contact:	Carl Bass
Other PSG Participants:	John Stewart
AA Individuals:	Dave Duncan, Deb Cash, Patty Grutzmacher, Jennifer Stevenson

Issue 1

Was the minimum capitalization and control requirements met in LJMII to support deconsolidation by Enron?

Resolution

Yes, LJMII was capitalized with 46% ($54 million/$118 million) third party equity (which excludes equity of the Managing Member) which exceeded the required 3%.

The Managing Member did not control LJMII because the following provisions in the LJMII partnership agreement were considered sufficient to overcome the presumption that the Enron related party, who was the Managing Member, controls:

- Although the General Partner had full control over the business and affairs of LJMII, an Advisory Committee ("AC"), which was solely appointed by the GP, had specific duties outlined in the partnership agreement, such as periodic reviews of asset valuations
- The senior officer was required to promptly provide information to the AC members relating to any transaction between LJMII and Enron or any of its subsidiaries.
- The GP of LJMII may be removed without cause with the recommendation of two-thirds of the AC and a vote of Limited Partners that represents 75% of the total LP interests (subsequently amended to require the majority of the AC and 2/3 of the total LP interests).
- With the consent of the majority, the LPs have the right to remove any AC member without cause.
- The LP's have various participating rights (i.e., acquisitions above a specified threshold).

Because of the above criteria, we believe that nonconsolidation of LJMII is appropriate.

Andersen
ENERGY

Redacted

To: John E. Stewart@ANDERSEN WO
cc:
Date: 09/25/2001 02:05 PM
From: Carl E. Bass, Houston, 237 / 2314
Subject: Raptor memos

FYI.

---------- Forwarded by Carl E. Bass on 09/25/2001 02:04 PM ----------

To: Debra A. Cash@ANDERSEN WO, David B. Duncan@ANDERSEN WO, Michael C. Odom@ANDERSEN WO
cc:
Date: 09/25/2001 02:05 PM
From: Carl E. Bass, Houston, 237 / 2314
Subject: Raptor memos

I have several comments on the memos attached to the Lotus Notes from Dave Duncan, dated September, 14, 2000. Please note that these are the first copies of these memos that I have seen.

1. Memo dated December 31, 1999 – This memo discusses the second structure, that is LJM II. I was not consulted on Issues 2 or 3 discussed in this memo. I recall being consulted at some point in the process on Issue 1 in this memo. This is consistent with Interpretation I-2 (p. 330) in our publication, *Accounting for Leases.*

2. Memo dated March 28, 2000 – The memo should clearly state which issues I was consulted on, those being Issues 1, 2, and 6. With respect to Issue 2, you may want to consider that the use of the cost method in effect does not permit any "upside" income effect with respect to Enron share price movement but that the impairment test for each entity will require any "downside" movement of Enron stock to be accounted for prior to settlement. With respect to Issue 6, the memo also implies that the value of the Enron shares used in the impairment test includes the restriction in order to determine fair value (see also third paragraph under caption entitled "Transaction Structure"). I note that the memo dated May 9, 2001 is inconsistent with that accounting. I believe the March 28, 2000 memo should make clear that the valuation of the stock is done using fair value. I am not aware that we ever discussed "how to fair value." I was not consulted on the other issues. Finally, I am not aware that Ben Neuhausen was consulted on any of these issues at the time.

3. Memo dated July 28, 2000 – I was consulted on this issue and agree with the documentation.

4. Memo dated December 28, 2000 – The conclusion implies that I was consulted with and concurred with all issues discussed in this memo. That is not accurate. I was only consulted on whether the client could consider cross collateralized entities in the assessment of the creditworthiness of these entities. My advice at that time was that in order to assess the creditworthiness of the Raptor entities in their entirety, all of the Raptor entities would have to be cross collateralized, legally and substantively, for the full and complete term of the entities. Absent that, each entity would have to assessed individually. Two other

alternatives were discussed. Those included (1) allowing Enron to cross collateralize in the manner I discussed above, but that it could be done after yearend but before the release of the financial statements and (2) allowing Enron to transfer its separate interest in these entities to whichever entity was experiencing an impairment issue. With respect to alternative (1), although that would achieve true cross collateralized entities, the fact that it was accomplished after yearend was an audit and practice question as there was no definitive authoritative literature. With respect to alternative (2), I did not believe that there was any substance to this and you could not use unrecorded value in one instrument to offset a decline in value in an unrelated instrument. The engagement team's ultimate conclusion as described in this memo was not one that I was consulted on. Finally, John was not involved in this consultation directly. I did speak to John immediately after our discussions in order to let him know what transpired.

5. Memo dated May 9, 2001 – The assignment issue was also discussed in the consultation surrounding the creditworthiness issue as I have described in point 4 above (see the December 28, 2000 memo discussion). I believe that the memo should document my disagreement with that alternative even though that alternative was ultimately accepted by the engagement team.

Andersen
Professional Standards Group

To: David B. Duncan@ANDERSEN WO, Debra A. Cash@ANDERSEN WO
cc: Michael C. Odom@ANDERSEN WO
Date: 09/25/2001 02:50 PM
From: Benjamin S. Neuhausen, Chicago 33 W. Monroe, 50 / 72307
Subject: Re: Suggestions on Raptor memos

My only suggestions on the Raptor memos relate to the memo dated March 28, 2000.

1. The only issues in the memo that I recall being consulted on are Issue 4 on EPS implications and the EPS implications at the tail end of Issue 3. Therefore, I suggest that the concluding paragraph note that I was consulted on EPS issues.

2. With respect to the EPS issues in Issue 3, Enron purchased a put. I don't understand how a purchased put option could be dilutive. If it is net share settled, Enron will receive shares from the counterparty when the option is in the money, which is anti-dilutive. If it is physically settled, Enron will deliver shares to the counterparty. Because it is a purchased option, however, Enron would only exercise if the strike price were higher than the current market price at the time of exercise, which again is anti-dilutive.

3. In the discussion of issue 2, I think the memo would be stronger if it explained why the participation of a senior officer of Enron in LJM-Talon does not provide Enron with an ability to exercise significant influence over Talon. Some of the discussion from the December 31, 1999 memo regarding the powers of the Advisory Committee might be incorporated into the March 31 memo.

Benjamin S. Neuhausen

10/1/01

Raptor Analysis

1) The company's calculation of impairment of its receivables from the Raptor entities through the second quarter indicated an impairment loss of $37 million. That calculation however, aggregated net losses from one Raptor entity with net gains from other Raptor entities. If we conclude that that aggregation is inappropriate, the issue is whether the financial statements are materially misstated, thereby requiring restatement of the first or second quarter.
2) Had the company applied its impairment calculation separately for each Raptor entity (i.e. not aggregated), a preliminary analysis suggests that the impairment loss would have been materially greater. That fact suggests that restatement may be necessary.
3) However, had the company measured its impairment differently, using a method allowable under GAAP, perhaps the resulting impairment charge would not have been materially different from the $37 million loss the company has recorded. If so, no restatement may be appropriate.
4) Some of the issues that the company must address are:
   a) Did the company adopt an accounting principle for calculating its impairment charge in the first and second quarters, even if the company misapplied that calculation? That is, does the misapplication of an accounting principle nevertheless lock the company into that application? Or, is the company free to choose any acceptable method of evaluating impairment in assessing whether it needs to restate?
      i) In making this assessment, we strongly recommend that we inform the company immediately of our conclusion that aggregation is not acceptable, so that the company can begin the process of determining the possible need for restatement.
      ii) In evaluating whether the company is free to choose an accounting method, the company should consider at least:
         (1) Its practice and written materials related to the Raptor transactions from inception (early in 2000) to date and to what extent it has defined and applied a certain method of assessing the impairment of its receivables from the Raptor entities
         (2) Its practice and written materials related to assessing impairment with other transactions
         (3) Any disclosures in its public filings that address its accounting principle or methods for assessing impairment
   b) If the company is free to choose its method, would the following be acceptable under GAAP?
      i) The company would assess whether its receivables are impaired using judgment, rather than an objective formula, in determining whether it is probable that the company would not collect its receivables as contractually due.

ii) To guide the company's judgment, the company would apply the following:
   (1) Derivatives related to certain volatile equity investments are driving many of the Raptor entities' liabilities. The company would conclude that any derivative indexed to an equity investment that has been "underwater" (i.e. resulted in a liability related to the derivative) for more than 6 months has experienced an "other than temporary decline" in value. That is, the company would value those derivatives at fair value at the date of the impairment assessment and would not assume that the value of the underlying equity security would increase in the future.
   (2) The company would value any derivative related to a company in bankruptcy at fair value at the date of impairment and would not assume that that value of the underlying equity security would increase.
   (3) The company would value derivatives on equity investments that are "close to cash burnout" at their fair value at the date of the impairment assessment and would not assume that the value of the underlying equity security would increase in the future. For purposes of this test, close to cash burnout means that the related entity is consuming cash at a rate that would eliminate its cash resources, including currently available financing, within one year from the date of the impairment test.
   (4) For all other derivatives that are driving the Raptor entities' liabilities and assets, the company would perform some quantitative analysis (using Monte Carlo simulation or other analysis) to estimate either value or future cash flows for purposes of assessing impairment. Those methods necessarily involve considerable judgment. However, the quantitative analysis should start with and be consistent with the current fair value of the instrument.

iii) We would accept the method outlined above, assuming that the company is free to choose its method, and it elected to follow an approach with those attributes. Whether the company needed to restate the first two quarters would be dependent on the results of applying the method outlined above to the company's particular facts.

5) To assist with our analysis of the company's position, we will need the following facts:
   a) What is the company's position on whether it is free to choose an accounting method to assess whether it needs to restate its quarters (see item 4a above) (i.e. Does the company believe that it has established and accounting policy or method for assessing impairment for its receivables related to the Raptor entities?)
   b) Assuming that the company is free to choose its method of assessing impairment, which method does is choose?
   c) Which companies that are driving Raptor entities' liabilities have been "underwater" for more than 6 months?
   d) Which companies that are driving the Raptor entities' liabilities are in bankruptcy? When did those companies declare bankruptcy?
   e) Which companies that that are driving the Raptor entities' liabilities are near "cash burnout"?

f) Did the company purchase the equity interest in the Raptor entities in the third quarter, thereby locking in the total loss from those transactions?
g) Did Raptor hedge with the company a decline in the company's stock price? If so, when and at what stock price?
h) What has the company disclosed to date in its 2000 and first and second quarter 2001 filings about the Raptor transactions?
?
i) Are the company's receivables from the Raptor entities "loans" (and thus fall under Statement 114) or "securities" (and fall under Statement 115)?
j) Within the Raptor entities, is the third party equity always in the most subordinate position relative to all other Raptor liabilities and claims?

ARTHUR ANDERSEN

To: The Files

From: Dave Duncan
Deb Cash
Patty Grutzmacher
Jennifer Stevenson

Date: December 31, 1999

Subject: LJMII Partnership Structure

Background

We were informed by a senior officer of Enron (CFO) that he saw a unique opportunity to match various capital providers wanting to diversify into sectors in which he had experience with needs Enron and other companies like Enron had for high degrees of third party equity capital. In effect, he wanted to form his own private equity fund similar to others he had observed in the market place which made sizable private investments and whose participants included sophisticated investors. He had explored this notion with other members of Enron's upper management who indicated a willingness for him to develop this idea. He further indicated that both he and they hoped that he could accomplish this and remain with the Company. While he and the Company planned to consider and address the obvious Corporate Governance and Fiduciary responsibility issues, we were asked by he and other members of Enron management to review the entity as it was developed to determine whether necessary features existed which would enable Enron to do transactions with the entity that would result in third party accounting recognition. Our deliberations with respect to such entity are described below.

Structure

On December 20, 1999, a private investment company, LJMII Co-Investment L.P. ("LJMII") was created for the purpose of acquiring or investing in primarily energy-related or communications-related businesses or activities.

LJMII was capitalized at formation with $55 million of equity and $63 million of debt capital. As indicated in the attached diagram (Diagram 1), the equity holders are comprised of a senior officer of Enron (2% ownership and General Partner) and various third party investors (98% ownership). The composition of the 98% third party investor ownership, which were 51 entities in total, are as follows: Financial Institutions (37%), Pension Funds (22%), Independents (19%), Insurance Co. (10%), Other funds (8%) and Foundations (4%). A portion of the debt was provided by an entity that is wholly owned by a joint venture in which Enron is a co-owner, and the remaining debt was provided by a third party bank.

Since LJMII planned to transact at least initially with Enron, we determined that we should view LJMII as an Enron sponsored SPE. We informed Enron that, at some point, we might reconsider our view of LJMII as an SPE and that such reconsideration would be based on the number of third party transactions and the size of those transactions to the operations of the entity as a whole. Since we considered LJMII to be an SPE, we informed Enron and LJMII that we would subject LJMII to the capital and control tests set forth in EITF 90-15 and Topic D-14 before any transactions between the two entities could be given accounting recognition for Enron. Additionally, because of the significant senior officer involvement we needed to determine that 1) the senior officer did not control the partnership and 2) certain criteria existed to provide assurance that all transactions executed between Enron and LJMII involved the input of the outside investors to preclude the appearance of self dealing.

Issues

Date: December 31, 1999

Subject: LJMII Partnership Structure

1. Is the minimum SPE capitalization requirement met to support nonconsolidation?
2. Does the control structure support nonconsolidation of the entity for Enron Corp. as a result of the related party relationship?
3. What are the necessary disclosures?

Issue 1

EITF 90-15 requires SPE structures to be capitalized with at least 3% third party residual equity. As a result of the senior officer equity ownership (which we determined should not be given any credit when determining whether sufficient capital existed when evaluating potential transactions with Enron), we determined that the required amount of equity would need to be 3.02% as opposed to the normal 3% (to effectively discount for the proportionate share of the officer's ownership). The balance sheet of LJMII consists of $55 million of funded equity capital and $63 million of debt. Total funded third party equity of LJMII is $54 million, as indicated on the attached diagram. As this represented approximately 45% of the total capitalization, we determined that the SPE capital threshold was met with respect to any transaction LJMII may undertake directly with Enron.

Issue 2

Topic D-14 states that the SEC staff believes that for nonconsolidation by the sponsor to be appropriate, the majority owner of the SPE must be an independent third party who has made a substantive capital investment in the SPE, has control of the SPE and has substantive risks and rewards of ownership of the assets of the SPE. The $54 million of LJMII equity that was contributed by third party investors represents a substantive capital investment. As indicated, a senior officer of Enron serves as the GP of LJMII and is therefore in control of day-to-day operations of the partnership. To overcome the presumption of control by the GP (and by association, Enron) for purposes of consolidation, we noted that the Partnership Agreement included the provision that the GP can be removed without cause with the recommendation of two-thirds of the AC and a vote of Limited Partners (LP) that represents 75% of the total LP interests. With respect to the inclusion of criteria to ensure LP involvement in transactions with Enron, we noted that an Advisory Committee ("AC") existed with specific duties outlined in the partnership agreement. These duties included, among other things, reviewing and approving all transactions between LJMII and Enron or any of its subsidiaries above certain thresholds. We determined that transactions below the thresholds would probably not be material to Enron, but we informed management we would have to review such situations on a case-by-case basis. We noted that, the AC consists of representatives of the limited partners, all of whom we noted were independent from Enron (2 pension fund representatives, 4 financial institution members, 1 independent and 1 insurance company). Although we noted that the AC members are appointed by the GP, we noted that all other LP had the right to remove any AC member without cause with the consent of 75% of the LP's. We concluded that these provisions were sufficient to overcome the presumption that the GP (and by association Enron) controls and that nonconsolidation of LJMII is therefore appropriate. We informed the client that, while the removal of the GP without cause feature generally was sufficient to overcome a presumption of control by the GP, an important consideration was the reasonableness of the ability of the LP's to do so. We noted that the existing feature (two-thirds of AC and 75% of the LP's) was at the very upper limit of what may be acceptable. We encouraged them to request LJMII to lower these thresholds before any material transactions were consummated.

Issue 3

Since the GP of LJMII is a related party, as transactions are entered into with Enron or its affiliates,

Date: December 31, 1999

Subject: LJMII Partnership Structure

certain disclosures will be required. We informed the client that the existence of LJMII will need to be disclosed, including the related party that serves as the GP of the partnership, as well as the purpose of the entity. The nature of transactions executed with Enron and Enron affiliates must also be disclosed as well as any associated gains or losses. We will review the filings and other issuances of financial statements to ensure all appropriate disclosure requirements are met.

Conclusion

We concurred with Enron that the necessary capitalization and control features had been met for nonconsolidation of LJMII and that recognition could be given to transactions with LJMII as a third party.

We informed management that this conclusion would need to be reviewed as transactions occurred and that we would need to address the audit evidence we would require (particularly with respect to the valuation of transactions between the two entities) on a case-by-case basis as they occurred.

We discussed these issues with Carl Bass and John Stewart of the Professional Standards Group, who concurred with our conclusions. We also reviewed the formation of this entity and our conclusions with Mike Odom, Practice Director, Bill Swanson, ABA Head, and Mike Lowther, concurring partner.

Additional Note

In addition to the technical accounting issues, we also considered Enron corporate governance issues related to these transactions. We discussed with Enron management (other than the senior officer involved) their planned activities to ensure such issues had been considered. We determined that Enron was receiving advice from internal and external counsel regarding the acceptability of the transactions and planned to disclose the formation of the entity and any contemplated transactions between the entity and Enron with the Finance Committee of the Board of Directors of Enron prior to their completion. In connection with our procedures, we confirmed that all of the above occurred. We also ensured that the Audit Committee was made aware of the entity and related transactions.

ARTHUR ANDERSEN

To: The Files

From: Dave Duncan
Deb Cash
Patty Grutzmacher
Jennifer Stevenson

Date: December 31, 1999, as amended, October 12, 2001

Subject: LJMII Partnership Structure

Background

We were informed by a senior officer of Enron (CFO) that he saw a unique opportunity to match various capital providers wanting to diversify into sectors in which he had experience with needs Enron and other companies like Enron had for high degrees of third party equity capital. In effect, he wanted to form his own private equity fund similar to others he had observed in the market place which made sizable private investments and whose participants included sophisticated investors. He had explored this notion with other members of Enron's upper management who indicated a willingness for him to develop this idea. He further indicated that both he and they hoped that he could accomplish this and remain with the Company. While he and the Company planned to consider and address the obvious Corporate Governance and Fiduciary responsibility issues, we were asked by he and other members of Enron management to review the entity as it was developed to determine whether necessary features existed which would enable Enron to do transactions with the entity that would result in third party accounting recognition. Our deliberations with respect to such entity are described below.

Structure

On December 20, 1999, a private investment company, LJMII Co-Investment L.P. ("LJMII") was created for the purpose of acquiring or investing in primarily energy-related or communications-related businesses or activities.

LJMII was capitalized at formation with $55 million of equity and $63 million of debt capital. As indicated in the attached diagram (Diagram I), the equity holders are comprised of a senior officer of Enron (2% ownership and General Partner) and various third party investors (98% ownership). The composition of the 98% third party investor ownership, which were 51 entities in total, are as follows: Financial Institutions (37%), Pension Funds (22%), Independents (19%), Insurance Co. (10%), Other funds (8%) and Foundations (4%). A portion of the debt was provided by an entity that is wholly owned by a joint venture in which Enron is a co-owner, and the remaining debt was provided by a third party bank.

Since LJMII planned to transact at least initially with Enron, we determined that we should view LJMII as an Enron sponsored SPE. We informed Enron that, at some point, we might reconsider our view of LJMII as an SPE and that such reconsideration would be based on the number of third party transactions and the size of those transactions to the operations of the entity as a whole. Since we considered LJMII to be an SPE, we informed Enron and LJMII that we would subject LJMII to the capital and control tests set forth in EITF 90-15 and Topic D-14 before any transactions between the two entities could be given accounting recognition for Enron. Additionally, because of the significant senior officer involvement we needed to determine that 1) the senior officer did not control the partnership and 2) certain criteria existed to provide assurance that all transactions executed between Enron and LJMII involved the input of the outside investors to preclude the appearance of self dealing.

Date: December 31, 1999

Subject: LJMII Partnership Structure

Issues

1. Is the minimum SPE capitalization requirement met to support nonconsolidation?
2. Does the control structure support nonconsolidation of the entity for Enron Corp. as a result of the related party relationship?
3. What are the necessary disclosures?

Issue 1

EITF 90-15 requires SPE structures to be capitalized with at least 3% third party residual equity. As a result of the senior officer equity ownership (which we determined should not be given any credit when determining whether sufficient capital existed when evaluating potential transactions with Enron), we determined that the required amount of equity would need to be 3.02% as opposed to the normal 3% (to effectively discount for the proportionate share of the officer's ownership). The balance sheet of LJMII consists of $55 million of funded equity capital and $63 million of debt. Total funded third party equity of LJMII is $54 million, as indicated on the attached diagram. As this represented approximately 45% of the total capitalization, we determined that the SPE capital threshold was met with respect to any transaction LJMII may undertake directly with Enron.

We discussed this issue with Carl Bass and John Stewart of the Professional Standards Group, who concurred with our conclusions.

Issue 2

Topic D-14 states that the SEC staff believes that for nonconsolidation by the sponsor to be appropriate, the majority owner of the SPE must be an independent third party who has made a substantive capital investment in the SPE, has control of the SPE and has substantive risks and rewards of ownership of the assets of the SPE. The $54 million of LJMII equity that was contributed by third party investors represents a substantive capital investment. As indicated, a senior officer of Enron serves as the GP of LJMII and is therefore in control of day-to-day operations of the partnership. To overcome the presumption of control by the GP (and by association, Enron) for purposes of consolidation, we noted that the Partnership Agreement included the provision that the GP can be removed without cause with the recommendation of two-thirds of the AC and a vote of Limited Partners (LP) that represents 75% of the total LP interests. With respect to the inclusion of criteria to ensure LP involvement in transactions with Enron, we noted that an Advisory Committee ("AC") existed with specific duties outlined in the partnership agreement. These duties included, among other things, reviewing and approving all transactions between LJMII and Enron or any of its subsidiaries above certain thresholds. We determined that transactions below the thresholds would probably not be material to Enron, but we informed management we would have to review such situations on a case-by-case basis. We noted that, the AC consists of representatives of the limited partners, all of whom we noted were independent from Enron (2 pension fund representatives, 4 financial institution members, 1 independent and 1 insurance company). Although we noted that the AC members are appointed by the GP, we noted that all other LP had the right to remove any AC member without cause with the consent of 75% of the LP's. We concluded that these provisions were sufficient to overcome the presumption that the GP (and by association Enron) controls and that nonconsolidation of LJMII is therefore appropriate. We informed the client that, while the removal of the GP without cause feature generally was sufficient to overcome a presumption of control by the GP, an important consideration was the reasonableness of the ability of the LP's to do so. We noted that the existing feature (two-thirds of AC and 75% of the LP's) was at the very upper limit of what may be acceptable. We

Date: December 31, 1999

Subject: LJMII Partnership Structure

encouraged them to request LJMII to lower these thresholds before any material transactions were consummated.

Issue 3

Since the GP of LJMII is a related party, as transactions are entered into with Enron or its affiliates, certain disclosures will be required. We informed the client that the existence of LJMII will need to be disclosed, including the related party that serves as the GP of the partnership, as well as the purpose of the entity. The nature of transactions executed with Enron and Enron affiliates must also be disclosed as well as any associated gains or losses. We will review the filings and other issuances of financial statements to ensure all appropriate disclosure requirements are met.

Conclusion

We concurred with Enron that the necessary capitalization and control features had been met for nonconsolidation of LJMII and that recognition could be given to transactions with LJMII as a third party.

We informed management that this conclusion would need to be reviewed as transactions occurred and that we would need to address the audit evidence we would require (particularly with respect to the valuation of transactions between the two entities) on a case-by-case basis as they occurred.

We discussed the formation of this entity and our conclusions with Mike Odom, Practice Director, Bill Swanson, ABA Head, and Mike Lowther, concurring partner, concurred with our conclusions.

Additional Note

In addition to the technical accounting issues, we also considered Enron corporate governance issues related to these transactions. We discussed with Enron management (other than the senior officer involved) their planned activities to ensure such issues had been considered. We determined that Enron was receiving advice from internal and external counsel regarding the acceptability of the transactions and planned to disclose the formation of the entity and any contemplated transactions between the entity and Enron with the Finance Committee of the Board of Directors of Enron prior to their completion. In connection with our procedures, we confirmed that all of the above occurred. We also ensured that the Audit Committee was made aware of the entity and related transactions.

Memo

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ANDERSEN

To	The Files
From	Dave Duncan Deb Cash Patty Grutzmacher Jennifer Stevenson
Date	March 28, 2000
Subject	Raptor Transaction

Purpose

The creation of a vehicle used to hedge Enron's exposure related to equity investments (accounted for under either fair value or accrual accounting).

Transaction Structure

Under the transaction structure shown in the attached diagram (Exhibit I). Enron, Harrier LLC (Harrier), a wholly-owned subsidiary of Enron, and Talon LLC (Talon) executed a series of agreements that result in Harrier acquiring the right to execute equity swap transactions up to a notional amount of $1 billion, or purchase put options through the conversion of a $400 million note receivable from Talon LLC into option premiums. Talon is an SPE that is capitalized by LJMII, a third party equity holder, who serves as the managing equity holder of Talon, and Enron Corp. who has a preferred LP interest. LJMII is a related party entity (See LJMII memo in 4th quarter file for an explanation of the relationship).

In the structure, Talon receives the following from Harrier:

1. A $50 million interest bearing note receivable, payable quarterly @ 7%;
2. 3,739,175 shares of Enron common stock which is restricted from sale for 3 years;
3. A contingent right to 3,876,755 of Enron common stock which could be delivered to Talon during 2003, subject to certain conditions being met (the "contingent forward") and which would be restricted from sale until 2005.;
4. A premium of $41million for writing an Enron common stock share settled put option on 7,171,418 shares at a strike price of $57.50/share, which expires 6 months from the closing date; and
5. A nominal net capital contribution of $1,000 from Enron for its preferred LP interest.

The value of the Enron shares, given the restrictions, has been determined to be approximately $350 million, as compared to the current value of a similar number of unrestricted Enron shares in the public market, which would be approximately $536 million.

Harrier receives the following from Talon:

1. A $400 million note receivable that is convertible into option premiums, subject to Talon approval.
2. The ability to enter into derivatives, subject to Talon's approval, with a cumulative notional amount of $1 billion;
3. A non-voting preferred limited liability company interest in Talon; and
4. A put option on Enron common stock whereby Enron has the obligation to deliver Enron shares to Talon for settlement below a stock price of $57.50.

The obligations under this transaction will terminate upon the earliest occurrence of one of the following: (1)April 18, 2005, (2)the date either Talon or Harrier wish to terminate the agreement provided the proper notice is given, and (3)a default event, as defined in the various transaction documents. Termination of this agreement by one of the above circumstances only terminates Harrier's right and Talon's obligation to execute additional derivatives. Previously executed derivatives will remain in effect and do not automatically terminate without mutual consent of the parties.

Issues

1. Does the structure of Talon meet the minimum control requirements of a special purpose entity that supports non-consolidation by Enron? What are the initial and ongoing capitalization requirements of the SPE?
2. How should Enron account for its preferred limited liability company interest in Talon?
3. How should Enron account for the purchased share-settled put option?
4. What is the proper accounting for the contingent forward sales contract?
5. How will the value of the derivative transactions be substantiated?
6. What is the impact of Talon's credit worthiness on the value of the derivative instruments to Harrier?
7. What are the required disclosures in the Enron Corp. financial statements as a result of the transaction?

Issue 1

The sponsor of the Talon SPE is Harrier. As mentioned, the SPE was capitalized by an independent third party member, LJMII, who infused $30 million of equity as its initial capital investment that will be at risk during the term of the structure. Harrier, who also made a $1,000 capital investment, serves as the other member of the SPE. In analyzing whether non-consolidation is appropriate, specific control criteria must be met, and the initial and ongoing capital investment must be 3% of the total assets of the SPE.

Control Requirements

Based on Topic D-14, "Transactions Involving Special-Purpose Entities," the SEC staff believes that for non-consolidation recognition by the sponsor to be appropriate, the majority owner of the SPE must be an independent third party who has made a substantive capital investment in the SPE, has control of the SPE and has substantive risks and rewards of ownership of the assets of the SPE.

LJMII serves as the managing member of the SPE. Harrier has no involvement in the management or operations of the entity. Therefore the control requirements are met.

Capital Requirements
The typical capital requirement of an SPE is 3% residual equity at risk of the total assets of the entity in question. In considering this requirement as it relates to Talon, we considered the following:

1. The required equity capital was coming from LJMII, an investment partnership we knew to 1) include an Enron employee among its capital participants and 2) have debt in its overall capital structure. Accordingly, we needed to determine that the capital we were considering in our test was not attributable to the Enron employee (we had previously determined that we would not consider such capital as "qualifying" equity capital as it related to structured transactions with Enron) or borrowed capital (which does not qualify in any instance). We reviewed LJMII's balance sheet to confirm it had sufficient equity capital to finance its contribution to Talon exclusive of its debt capital and the Enron employee capital. We determined this to be the case and concluded that all of the LJMII contribution could be considered for purposes of the required capital test. We grossed-up the required capital amount to effectively discount the Enron employee's proportionate share of LJM II capital.

   We discussed this issue with John Stewart of the Professional Standards Group who concurred with our conclusions.

2. As a part of the transaction origination, we noted that organizational expenses were being paid by Harrier directly to applicable third party vendors on behalf of Talon. Because these expenses are incurred by the SPE, but paid by Enron, we determined that they should be included in the 3% capital requirement analysis consistent with how we have seen this situation addressed in other SPE situations in practice.

3. It was contemplated that Talon would be entering into derivative transactions which might include swaps. Typically swaps done "at-the-money" have little to zero asset value at origination. We noted that using zero as the asset value for purposes of determining the minimum required amount of capital for these type instruments may not be reasonable, particularly as the instruments notional amount (maximum potential for loss) increased. We informed the company that we believed the minimum should be calculated on the notional amount (maximum potential for loss) of any such instruments and that we would follow that principle in applying the test.

   We discussed this issue with John Stewart, Professional Standards Group, who concurred with our conclusions.

   Although the option to redesignate earnings of the entity to capital at risk (see Redesignation memo dated March 28, 2000) is available, the terms of this transaction structure does not meet criteria 4:

therefore, redesignation is not available. Therefore, as the maximum exposure of the entity changes (i.e. through leveraging Talon or increasing the notional capacity of derivatives), LJMII will be required to provide additional equity to capitalize the entity.

We discussed all the above matters in Issue 1 with Carl Bass of the Professional Standards Group who concurred with our conclusions.

Issue 2

Harrier's preferred interest in Talon gives Enron the right to receive earnings from the entity that exceed certain earnings thresholds of the LJMII member as stated in the Talon Partnership Agreement. We noted that this interest is only settlable in cash (i.e., Enron cannot take any Enron shares Talon may hold in settlement). We considered whether it should be viewed as a derivative instrument. However, based on the form of the investment and the definition of a derivative as stated in SFAS 133, the form of the instrument is an investment and therefore should not be accounted for as a derivative.

Based on Topic D-46, a limited partnership investment should be accounted for using the equity method unless the investor's interest "is so minor that the limited partner may have virtually no influence over partnership operating and financial policies." The SEC staff understands that practice generally has viewed investments of more than 3 to 5 percent to be more than minor. As indicated in the Issue 1 discussion, Harrier, Enron's wholly owned subsidiary, has an investment of less than 1% and no voting rights as a member. (See also memo dated December 31, 1999 regarding the powers of the Advisory Committee and LP's). Accordingly, we concluded that the investment should be accounted for under the cost method on the balance sheet of Enron Corp.

We also noted that the result of the structure could be that, through this investment or through its other transactions with Talon, Enron may generate a gain (or offset losses) with economic benefits from Talon that could include the effects of changes in value of its own stock. Important to our consideration of this potential was that 1) the stock was to be considered issued and outstanding and 2) Talon had effective ownership of the risk and rewards of the shares and 3) Enron had no rights to ultimate settlement of anything that may accrue to Enron in shares (Enron could only receive settlement in cash). We noted that, when evaluated as a whole, the structure had analogous characteristics to a derivative in Enron's own stock settlable only in cash. As the change in value of such derivatives is required to impact income, we concluded that this potential outcome as it related to Talon was acceptable.

We discussed this issue with Carl Bass of the Professional Standards Group who concurred with our conclusions.

Issue 3

Enron purchased an option for $41 million whereby Enron has the right to put 7,171,418 shares of Enron common stock to Talon at a strike price of $57.50, the settlement of which is in the form of Enron shares.

The put option was executed at market and contains the normal termination provisions granted under an ISDA Swap Agreement. Based on EITF 96-13 "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," contracts whose settlement is indexed to the company's own stock should follow specific accounting treatment based on the settlement method which could be share or cash settled. In March 2000, the EITF reached a consensus on EITF 00-7, "Application of Issue No. 96-13 to Equity Derivative Instruments That Contain Certain Provisions That Require Net Cash Settlement If Certain Events outside the Control of the Issuer Occur" which states that contracts that may require a cash payment by the issuer upon the occurrence of future events outside the control of the issuer cannot be accounted for as equity. Because this purchased put option is indexed to Enron's stock and is settled only in shares at Enron's option, we determined that this contract should be accounted for as an equity instrument. Accordingly, the cost of the option should be accounted for through equity as opposed to income. This treatment is also appropriate for the value of any shares indicated to be deliverable under the terms of the instrument as it is evaluated on a current market basis at each reporting date. In addition, any shares so indicated should be included in the EPS calculation for such period, assuming they are dilutive.

We discussed the EPS issue with Ben Neuhausen of the Professional Standards Group who concurred with our conclusions.

Issue 4

The shares under the contingent forward sales contract between Harrier and Talon are currently issued and outstanding for purposes of calculating EPS for Enron Corp. Through this structure, Harrier has the obligation to deliver approximately 3.8 million of these shares if the value of each share equals or exceeds $50.00. If the price of these shares is below $50.00, Talon bears the risk. As a result, AA's view is that these shares should be included in the number of issued and outstanding shares.

We discussed this issue with Ben Neuhausen of the Professional Standards Group who concurred with our conclusions.

Issue 5

At the close of the transaction, no derivative instruments were executed other than Enron's purchased put option which was priced at market. However, until the termination of the entity, Harrier has the right to execute equity swap and option positions with Talon, subject to Talon's approval. Because it will be important to ensure that all transactions are priced at fair value, we informed the company that we will likely request an independent third party appraisal or a fairness opinion on the value if it is not readily confirmable by us using available public or other third party information.

Issue 6

As the derivative instruments are valued, assets or liabilities will be recognized on the books of Talon and Harrier since these instruments will be carried at fair value. Consistent with the valuation of all derivatives, the value recognized by each party will be subject to the capacity of the other party to financially fulfill the obligation (i.e. creditworthiness). As a result, the credit ability of the other party will be factored into the value of the derivative. Therefore, as Harrier records an asset based on the value of the derivatives, its value will represent Talon's ability to pay. Talon's credit capacity is represented by the fair value of Talon's net assets. This includes the fair value of the Enron stock at the date of valuation. As a result, AA will review each quarter of Enron's calculation supporting the value of derivative instruments relative to Talon's credit capacity.

We discussed this issue with John Stewart and Carl Bass of the Professional Standards Group who concurred with our conclusions.

Issue 7

The managing member of Talon is an Enron related party and derivative transactions are executed between a wholly owned Enron subsidiary, Harrier, and Talon. As a result, certain disclosures are required. A description of the structure, its purpose and the related party nature of the parties involved should be reflected in the footnotes to the financial statements submitted in 10-Q and 10-K filings. We will review these filings to ensure all appropriate disclosure requirements are met.

Conclusion

We discussed the features of the structure with Mike Odom, Practice Director and Mike Lowther, concurring partner, who concurred with our conclusions.

Memo

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ANDERSEN

To The Files

From Dave Duncan
Deb Cash
Patty Grutzmacher
Jennifer Stevenson

Date March 28, 2000, as amended, October 12, 2001

Subject Raptor Transaction

Purpose

The creation of a vehicle used to hedge Enron's exposure related to equity investments (accounted for under either fair value or accrual accounting).

Transaction Structure

Under the transaction structure shown in the attached diagram (Exhibit I), Enron, Harrier LLC (Harrier), a wholly-owned subsidiary of Enron, and Talon LLC (Talon) executed a series of agreements that result in Harrier acquiring the right to execute equity swap transactions up to a notional amount of $1 billion, or purchase put options through the conversion of a $400 million note receivable from Talon LLC into option premiums. Talon is an SPE that is capitalized by LJMII, a third party equity holder, who serves as the managing equity holder of Talon, and Enron Corp. who has a preferred LP interest. LJMII is a related party entity (See LJMII memo in 4th quarter file for an explanation of the relationship).

In the structure, Talon receives the following from Harrier:

1. A $50 million interest bearing note receivable, payable quarterly @ 7%;
2. 3,739,175 shares of Enron common stock which is restricted from sale for 3 years;
3. A contingent right to 3,876,755 of Enron common stock which could be delivered to Talon during 2003, subject to certain conditions being met (the "contingent forward") and which would be restricted from sale until 2005.;
4. A premium of $41million for writing an Enron common stock share settled put option on 7,171,418 shares at a strike price of $57.50/share, which expires 6 months from the closing date; and
5. A nominal net capital contribution of $1,000 from Enron for its preferred LP interest.

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The value of the Enron shares, given the restrictions, has been determined to be approximately $350 million, as compared to the current value of a similar number of unrestricted Enron shares in the public market, which would be approximately $536 million.

Harrier receives the following from Talon:

1. A $400 million note receivable that is convertible into option premiums, subject to Talon approval;
2. The ability to enter into derivatives, subject to Talon's approval, with a cumulative notional amount of $1 billion;
3. A non-voting preferred limited liability company interest in Talon; and
4. A put option on Enron common stock whereby Enron has the obligation to deliver Enron shares to Talon for settlement below a stock price of $57.50.

The obligations under this transaction will terminate upon the earliest occurrence of one of the following: (1)April 18, 2005, (2)the date either Talon or Harrier wish to terminate the agreement provided the proper notice is given, and (3)a default event, as defined in the various transaction documents. Termination of this agreement by one of the above circumstances only terminates Harrier's right and Talon's obligation to execute additional derivatives. Previously executed derivatives will remain in effect and do not automatically terminate without mutual consent of the parties.

Issues

1. Does the structure of Talon meet the minimum control requirements of a special purpose entity that supports non-consolidation by Enron? What are the initial and ongoing capitalization requirements of the SPE?
2. How should Enron account for its preferred limited liability company interest in Talon?
3. How should Enron account for the purchased share-settled put option?
4. What is the proper accounting for the contingent forward sales contract?
5. How will the value of the derivative transactions be substantiated?
6. What is the impact of Talon's credit worthiness on the value of the derivative instruments to Harrier?
7. What are the required disclosures in the Enron Corp. financial statements as a result of the transaction?

Issue 1

The sponsor of the Talon SPE is Harrier. As mentioned, the SPE was capitalized by an independent third party member, LJMII, who infused $30 million of equity as its initial capital investment that will be at risk during the term of the structure. Harrier, who also made a $1,000 capital investment, serves as the other member of the SPE. In analyzing whether non-consolidation is appropriate, specific control criteria must be met, and the initial and ongoing capital investment must be 3% of the total assets of the SPE.

Control Requirements

Based on Topic D-14, "Transactions Involving Special-Purpose Entities," the SEC staff believes that for non-consolidation recognition by the sponsor to be appropriate, the majority owner of the SPE must be an independent third party who has made a substantive capital investment in the SPE, has control of the SPE and has substantive risks and rewards of ownership of the assets of the SPE.

LJMII serves as the managing member of the SPE. Harrier has no involvement in the management or operations of the entity. Therefore the control requirements are met.

Capital Requirements
The typical capital requirement of an SPE is 3% residual equity at risk of the total assets of the entity in question. In considering this requirement as it relates to Talon, we considered the following:

1. The required equity capital was coming from LJMII, an investment partnership we knew to 1) include an Enron employee among its capital participants and 2) have debt in its overall capital structure. Accordingly, we needed to determine that the capital we were considering in our test was not attributable to the Enron employee (we had previously determined that we would not consider such capital as "qualifying" equity capital as it related to structured transactions with Enron) or borrowed capital (which does not qualify in any instance). We reviewed LJMII's balance sheet to confirm it had sufficient equity capital to finance its contribution to Talon exclusive of its debt capital and the Enron employee capital. We determined this to be the case and concluded that all of the LJMII contribution could be considered for purposes of the required capital test. We grossed-up the required capital amount to effectively discount the Enron employee's proportionate share of LJM II capital.

   We discussed this issue with John Stewart of the Professional Standards Group who concurred with our conclusions.

2. As a part of the transaction origination, we noted that organizational expenses were being paid by Harrier directly to applicable third party vendors on behalf of Talon. Because these expenses are incurred by the SPE, but paid by Enron, we determined that they should be included in the 3% capital requirement analysis consistent with how we have seen this situation addressed in other SPE situations in practice.

3. It was contemplated that Talon would be entering into derivative transactions which might include swaps. Typically swaps done "at-the-money" have little to zero asset value at origination. We noted that using zero as the asset value for purposes of determining the minimum required amount of capital for these type instruments may not be reasonable, particularly as the instruments notional amount (maximum potential for loss) increased. We informed the company that we believed the minimum should be calculated on the notional amount (maximum potential for loss) of any such instruments and that we would follow that principle in applying the test.

   We discussed this issue with John Stewart, Professional Standards Group, who concurred with our conclusions.

Although the option to redesignate earnings of the entity to capital at risk (see Redesignation memo dated March 28, 2000) is available, the terms of this transaction structure does not meet criteria 4, therefore, redesignation is not available. Therefore, as the maximum exposure of the entity changes (i.e. through leveraging Talon or increasing the notional capacity of derivatives), LJMII will be required to provide additional equity to capitalize the entity.

We discussed all the above matters in Issue I with Carl Bass of the Professional Standards Group who concurred with our conclusions.

Issue 2

Harrier's preferred interest in Talon gives Enron the right to receive earnings from the entity that exceed certain earnings thresholds of the LJMII member as stated in the Talon Partnership Agreement. We noted that this interest is only settlable in cash (i.e., Enron cannot take any Enron shares Talon may hold in settlement). We considered whether it should be viewed as a derivative instrument. However, based on the form of the investment and the definition of a derivative as stated in SFAS 133, the form of the instrument is an investment and therefore should not be accounted for as a derivative.

Based on Topic D-46, a limited partnership investment should be accounted for using the equity method unless the investor's interest "is so minor that the limited partner may have virtually no influence over partnership operating and financial policies." The SEC staff understands that practice generally has viewed investments of more than 3 to 5 percent to be more than minor. As indicated in the Issue 1 discussion, Harrier, Enron's wholly owned subsidiary, has an investment of less than 1% and no voting rights as a member. (See also memo dated December 31, 1999 regarding the powers of the Advisory Committee and LP's). Accordingly, we concluded that the investment should be accounted for under the cost method on the balance sheet of Enron Corp.

We also noted that the result of the structure could be that, through this investment or through its other transactions with Talon, Enron may generate a gain (or offset losses) with economic benefits from Talon that could include the effects of changes in value of its own stock. Important to our consideration of this potential was that 1) the stock was to be considered issued and outstanding and 2) Talon had effective ownership of the risk and rewards of the shares and 3) Enron had no rights to ultimate settlement of anything that may accrue to Enron in shares (Enron could only receive settlement in cash). We noted that, when evaluated as a whole, the structure had analogous characteristics to a derivative in Enron's own stock settlable only in cash. As the change in value of such derivatives is required to impact income, we concluded that this potential outcome as it related to Talon was acceptable.

We discussed this issue with Carl Bass of the Professional Standards Group who concurred with our conclusions.

Issue 3

Enron purchased an option for $41 million whereby Enron has the right to put 7,171,418 shares of Enron common stock to Talon at a strike price of $57.50, the settlement of which is in the form of Enron shares. The put option was executed at market and contains the normal termination provisions granted under an ISDA Swap Agreement. Based on EITF 96-13 "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," contracts whose settlement is indexed to the company's own stock should follow specific accounting treatment based on the settlement method which could be share or cash settled. In March 2000, the EITF reached a consensus on EITF 00-7, "Application of Issue No. 96-13 to Equity Derivative Instruments That Contain Certain Provisions That Require Net Cash Settlement If Certain Events outside the Control of the Issuer Occur" which states that contracts that may require a cash payment by the issuer upon the occurrence of future events outside the control of the issuer cannot be accounted for as equity. Because this purchased put option is indexed to Enron's stock and is settled only in shares at Enron's option, we determined that this contract should be accounted for as an equity instrument. Accordingly, the cost of the option should be accounted for through equity as opposed to income. This treatment is also appropriate for the value of any shares indicated to be deliverable under the terms of the instrument as it is evaluated on a current market basis at each reporting date. In addition, any shares so indicated should be included in the EPS calculation for such period, assuming they are dilutive.

We discussed the EPS issue with Ben Neuhausen of the Professional Standards Group who concurred with our conclusions.

Issue 4

The shares under the contingent forward sales contract between Harrier and Talon are currently issued and outstanding for purposes of calculating EPS for Enron Corp. Through this structure, Harrier has the obligation to deliver approximately 3.8 million of these shares if the value of each share equals or exceeds $50.00. If the price of these shares is below $50.00, Talon bears the risk. As a result, AA's view is that these shares should be included in the number of issued and outstanding shares.

We discussed this issue with Ben Neuhausen of the Professional Standards Group who concurred with our conclusions.

Issue 5

At the close of the transaction, no derivative instruments were executed other than Enron's purchased put option which was priced at market. However, until the termination of the entity, Harrier has the right to execute equity swap and option positions with Talon, subject to Talon's approval. Because it will be important to ensure that all transactions are priced at fair value, we informed the company that we will likely request an independent third party appraisal or a fairness opinion on the value if it is not readily confirmable by us using available public or other third party information.

Issue 6

As the derivative instruments are valued, assets or liabilities will be recognized on the books of Talon and Harrier since these instruments will be carried at fair value. Consistent with the valuation of all derivatives, the value recognized by each party will be subject to the capacity of the other party to financially fulfill the obligation (i.e. creditworthiness). As a result, the credit ability of the other party will be factored into the value of the derivative. Therefore, as Harrier records an asset based on the value of the derivatives, its value will represent Talon's ability to pay. Talon's credit capacity is represented by the fair value of Talon's net assets. This includes the fair value of the Enron stock at the date of valuation. As a result, AA will review each quarter of Enron's calculation supporting the value of derivative instruments relative to Talon's credit capacity.

We discussed this issue with John Stewart and Carl Bass of the Professional Standards Group who concurred with our conclusions.

Issue 7

The managing member of Talon is an Enron related party and derivative transactions are executed between a wholly owned Enron subsidiary, Harrier, and Talon. As a result, certain disclosures are required. A description of the structure, its purpose and the related party nature of the parties involved should be reflected in the footnotes to the financial statements submitted in 10-Q and 10-K filings. We will review these filings to ensure all appropriate disclosure requirements are met.

Conclusion

We discussed the features of the structure with Mike Odom, Practice Director and Mike Lowther, concurring partner, who concurred with our conclusions.

Memo

ARTHUR ANDERSEN

Tel
Fax

To The Files

From Dave Duncan
Deb Cash
Jennifer Stevenson
Patty Grutzmacher

Date November 9, 2000

Subject Raptor 3 Transaction

Background

During the third quarter Enron structured a transaction (Raptor 3) that effectively produces the same results as the Raptor I, II and IV transactions that were previously executed during the year. Although the structure of Raptor 3 is slightly different, it provides Enron with additional capacity to hedge its exposure to certain investments.

Transaction Structure

As detailed in the attached diagram (Exhibit I), EES created EES Warrant Trust (the "Trust") with Class A and Class B Member Interests. The Class A Member Interest represents 100% of the voting interest and .01% of the economic interest of the Trust and the Class B Member Interest represents 99.99% of the economic interest. EES transferred to the Trust 120,589 warrants, that are convertible into 24,117,800 million shares in common stock of The New Power Company ("TNPC"), in return for the Class A Interest. Pronghorn, a wholly owned subsidiary of EES, holds the B-interest in the Trust.

Pronghorn transferred the Class B Member Interest, which meets the criteria of a financial asset, to a third party, Porcupine LLP. Enron's basis in the underlying assets of the Class B Member Interest, which are warrants, was $-0- prior to the transfer. In return for the Class B Member Interest, Porcupine issued a $259 million note receivable (the "Note") to Pronghorn that is solely collateralized by the Class B Member Interest.

Porcupine LLC (Porcupine) is an SPE that is capitalized by LJMII, who serves as the managing member and Pronghorn, who has a preferred LP interest. LJMII is a related party entity (See LJMII memo in 4th quarter 1999 file for an explanation of the relationship). The capital contribution of $30 million made by LJMII was contributed from equity of the entity and represents 3% of Porcupine's maximum exposure. Therefore the initial capital requirement was met. (See Exhibit II for the initial 3% test.)

Under the transaction structure shown in Exhibit I, Enron, Pronghorn and Porcupine executed a series of agreements that result in the right for Pronghorn to execute equity price swap transactions. This structure could serve as a hedging vehicle of certain investments held by Enron entities.

In addition to the transfer of the Class B Member Interest, Porcupine received a $50 million interest bearing note receivable, payable quarterly @ 7%, and a capital contribution of $1,000 from Pronghorn. Coupled with the $259 million note receivable, Pronghorn received a non-voting preferred limited liability company interest in Porcupine, and a $50 million interest bearing note receivable, payable semi-annually @ 7% from Porcupine.

The obligations under this transaction structure will terminate upon the earliest occurrence of one of the following: (1)September 27, 2005, (2)the date either Pronghorn or Porcupine wish to terminate the agreement provided the proper notice is given, and (3)a default event, as defined in the various transaction documents. Termination of this agreement by one of the above circumstances only terminates Pronghorn's right and Porcupine's obligation to execute additional derivatives. Previously executed derivative transactions will remain in effect and do not automatically terminate upon termination of the structure.

Accounting Issues

The unique accounting issue with the Raptor 3 structure is the accounting for the transfer of the Class B Member Interest. Although the Class B Member Interest qualifies as a financial asset and all the criteria of paragraph 9 of SFAS 125 "Financial Assets and Liabilities: Sales, Transfers & Extinguishments" are met, sales treatment is not appropriate. Per paragraph 33-1 of the AA Interpretation of SFAS 125, because the Note "is solely collateralized by the Class B Member Interest without recourse to the third-party investor, then, in effect, the Note represents a beneficial interest in the transferred asset that precludes sale accounting pursuant to paragraph 9 to the extent of the beneficial interest retained." Thus, the Note is treated as a retained interest and the carrying value of the retained interest is $-0- although the fair value of the retained interest is valued at approximately $259 million.

Other accounting issues related to this structure are identical to those within the other Raptor structures; therefore see the detailed discussion of accounting issues in the Raptor 1 memo.

Memo

ARTHUR ANDERSEN

Tel
Fax

To	The Files
From	Dave Duncan Deb Cash Jennifer Stevenson Patty Grutzmacher
Date	November 9, 2000, as amended, October 12, 2001
Subject	Raptor 3 Transaction

Background
During the third quarter Enron structured a transaction (Raptor 3) that effectively produces the same results as the Raptor I, II and IV transactions that were previously executed during the year. Although the structure of Raptor 3 is slightly different, it provides Enron with additional capacity to hedge its exposure to certain investments.

Transaction Structure
As detailed in the attached diagram (Exhibit I), EES created EES Warrant Trust (the "Trust") with Class A and Class B Member Interests. The Class A Member Interest represents 100% of the voting interest and .01% of the economic interest of the Trust and the Class B Member Interest represents 99.99% of the economic interest. EES transferred to the Trust 120,589 warrants, that are convertible into 24,117,800 million shares in common stock of The New Power Company ("TNPC"), in return for the Class A Interest. Pronghorn, a wholly owned subsidiary of EES, holds the B-interest in the Trust.

Pronghorn transferred the Class B Member Interest, which meets the criteria of a financial asset, to a third party, Porcupine LLP. Enron's basis in the underlying assets of the Class B Member Interest, which are warrants, was $-0- prior to the transfer. In return for the Class B Member Interest, Porcupine issued a $259 million note receivable (the "Note") to Pronghorn that is solely collateralized by the Class B Member Interest.

Porcupine LLC (Porcupine) is an SPE that is capitalized by LJMII, who serves as the managing member and Pronghorn, who has a preferred LP interest. LJMII is a related party entity (See LJMII memo in 4th quarter 1999 file for an explanation of the relationship). The capital contribution of $30 million made by LJMII was contributed from equity of the entity and represents 3% of Porcupine's maximum exposure. Therefore the initial capital requirement was met. (See Exhibit II for the initial 3% test.)

Under the transaction structure shown in Exhibit I, Enron, Pronghorn and Porcupine executed a series of agreements that result in the right for Pronghorn to execute equity price swap transactions. This structure could serve as a hedging vehicle of certain investments held by Enron entities.

In addition to the transfer of the Class B Member Interest, Porcupine received a $50 million interest bearing note receivable, payable quarterly @ 7%, and a capital contribution of $1,000 from Pronghorn. Coupled with the $259 million note receivable, Pronghorn received a non-voting preferred limited liability company interest in Porcupine, and a $50 million interest bearing note receivable, payable semi-annually @ 7% from Porcupine.

The obligations under this transaction structure will terminate upon the earliest occurrence of one of the following: (1)September 27, 2005, (2)the date either Pronghorn or Porcupine wish to terminate the agreement provided the proper notice is given, and (3)a default event, as defined in the various transaction documents. Termination of this agreement by one of the above circumstances only terminates Pronghorn's right and Porcupine's obligation to execute additional derivatives. Previously executed derivative transactions will remain in effect and do not automatically terminate upon termination of the structure.

Accounting Issues

The unique accounting issue with the Raptor 3 structure is the accounting for the transfer of the Class B Member Interest. Although the Class B Member Interest qualifies as a financial asset and all the criteria of paragraph 9 of SFAS 125 "Financial Assets and Liabilities: Sales, Transfers & Extinguishments" are met, sales treatment is not appropriate. Per paragraph 33-1 of the AA Interpretation of SFAS 125, because the Note "is solely collateralized by the Class B Member Interest without recourse to the third-party investor, then, in effect, the Note represents a beneficial interest in the transferred asset that precludes sale accounting pursuant to paragraph 9 to the extent of the beneficial interest retained." Thus, the Note is treated as a retained interest and the carrying value of the retained interest is $-0- although the fair value of the retained interest is valued at approximately $259 million.

Other accounting issues related to this structure are identical to those within the other Raptor structures; therefore see the detailed discussion of accounting issues in the Raptor 1 memo.

Memo

ANDERSEN

Tel
Fax

To The Files

From Dave Duncan
Deb Cash
Patty Grutzmacher
Jennifer Stevenson

Date December 28, 2000

Subject Raptor Structures Update

This memo provides an update on various transactions that have been executed within each of the Raptor structures since their inception. The detailed description of each Raptor structure may be found in the respective memos within the 2000 audit files.

Raptor 1

- The Enron share settled put that was to terminate in October 2000, was settled early on August 3, 2000, for a payment of $3.9 million (settled by an increase in the note receivable from Talon) by Talon to Enron based on the value of the unearned premium originally paid to Talon. Because the SPE, Talon, included the maximum exposure under the put in its 3% capital requirement test, the termination of this put created excess equity capital in the vehicle of approximately $412 million that can be utilized to execute derivative transactions. As a result of the early termination, the manager of Talon declared a distribution in the amount of $41 million in cash to be made by Talon to the LJMII member. This distribution was made in accordance with Section 5.1 of the Amended and Restated Limited Liability Company Agreement of Talon LLC, and satisfied the required return on the equity capital.

- On August 3, 2000, Talon sold a put option to Enron for a $36 million premium whereby Enron has the right to put certain of its equity investment price risks (related to those previously sold in the Merlin CLO Trust structure) to Talon up to $93 million (maximum payout). This put requires for payouts by Talon upon certain default events related to these investments. The maximum notional amount of this derivative reduced the available capacity of the entity by approximately $93 million, which represents the maximum payout by Talon under this put option.

- Equity price swaps and option transactions of approximately $730 million in notional value were executed to hedge the exposure of fair value investments of Enron North America and Enron Broadband Services. (See

J:\misc data\raptor final\1200raptorupdate.doc memo with details in the 3rd quarter ENA file) Capacity is available as a result of the early termination of the share settled put option between Enron and Talon, as described above, to support these instruments.

- On October 30, 2000, an equity collar transaction was executed on the 7,615,930 shares of Enron common stock in the vehicle at a floor price of $81 and a cap price of $116.12 This collar locks in the value of the Enron common stock between this floor and cap, therefore limiting Talon's exposure to the volatility of the Enron stock Enron's credit capacity test should reflect this transaction in assessing the value of Talon's assets

Raptor 2

- The Enron share settled put that was to terminate in December 2000, was settled early on September 22, 2000, for a payment of $6.7 million by Timberwolf to Enron based on the value of the unearned premium originally paid to Timberwolf Enron allowed Timberwolf to satisfy this payment obligation by increasing the payable amount of the note receivable from Timberwolf Because the SPE, Timberwolf, included the maximum exposure under the put in its 3% capital requirement test, the termination of this put created excess equity capital in the vehicle of approximately $427 million that can be utilized to execute additional derivative transactions As a result of the early termination, the manager of Timberwolf declared a distribution in the amount of $41 million in cash to be made by Timberwolf to the LJMII member. The distribution was made in accordance with Section 5.1 of the Amended and Restated Limited Liability Company Agreement of Timberwolf LLC, and satisfied the required return on the equity capital.

- On September 22, 2000, an equity swap transaction with a $460 million notional amount was executed to hedge Enron's exposure of three international investments that are accounted for under the equity method. These equity interests are in international local distribution companies that Enron management expects to sell to third parties The notional amount of the derivatives closely approximates Enron's book value in these assets. As of September 30, 2000 and December 30, 2000, the equity swap derivative had a fair value of 0. To support these values at each quarter end, Enron obtained an independent fair value from CSFB that supports the total fair value and restriction discount that should be allocated due to the restrictive nature of these assets.

- On November 27, 2000, an equity collar transaction was executed on the 7,809,790 shares of Enron common stock in the vehicle at a floor price of $78.875 and a cap price of $111.8633. This collar locks in the value of the Enron common stock between this floor and cap, therefore limiting Timberwolf's exposure to the volatility of the Enron stock Enron's credit capacity test should reflect this transaction in assessing the value of Timberwolf's assets

- On December 28, 2000, an equity collar and swap transaction was executed to hedge ENA's exposure to one of its merchant investments Because the combination of the transactions netted to a maximum exposure to the vehicle of approximately $53 million, that amount reduced the available capacity.

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Raptor 3

- Three swap transactions were executed on October 22, 2000, to hedge Enron's exposure in several total return swaps relating to three series of trusts (McGarrett within the Hawaii 125-0 Trust structure (see the applicable memo in the EES file for a detailed description of the transaction and related accounting issues). The total return swaps expose Enron to the volatility of approximately 90,000 warrants that are convertible into 18,000,000 shares of common stock of The New Power Company ("TNPC"). Therefore these swaps within Raptor 3 were executed to mitigate Enron's exposure to the price volatility of TNPC stock. As a result of these swaps, Porcupine is now exposed to changes in the value of TNPC shares. The initial price at the date of execution of the swaps was $10.75 per share of common stock.

Raptor 4

- No transactions have been executed to date.

As noted in our transaction memos, we review quarterly Enron's assessment of the adequacy of the credit capacity of each of the Raptor vehicles because Enron has various notes and derivatives with these entities. Consistent with the valuation of all notes and derivatives, the value recognized by each party is subject to the capacity of the other party to financially fulfill the obligation (i.e. creditworthiness). As a result, the creditworthiness of Raptor will be factored into the value of the derivative and in assessing the collectibility of the notes. Therefore, as Enron records an asset based on the value of the derivatives, its value may be impaired based on each entity's ability to pay.

To mitigate Enron's exposure to the potential decline in creditworthiness of each of the Raptor vehicles, Enron negotiated and executed an agreement with LJM, as equity holders in each of the Raptor vehicles, in December 2000. Under the agreement, the assets of each entity, Talon, Timberwolf, Porcupine and Bobcat, with the exception of the Promissory Note dated September 27, 2000, by Porcupine in favor of Pronghorn I LLC, were cross collateralized for the benefit of the creditors of each entity for a 45 day period. As consideration for this cross-collateral protection, Enron agreed to pay $50,000 to LJMII. AA concluded that this cross collateralization would allow Enron to benefit from the assets of each entity on an aggregate basis in assessing the credit capacity of the entities as of December 31, 2000.

We discussed this conclusion with the Professional Standards Group (PSG) in Chicago, Carl Bass and John Stewart, and Mike Odom, Practice Director, who concurred with our conclusion.

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Memo

ANDERSEN

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AAHEC(2)03376.1

To The Files

From Dave Duncan
Deb Cash
Patty Grutzmacher
Jennifer Stevenson

Date December 28, 2000, as amended, October 12, 2001

Subject Raptor Structures Update

This memo provides an update on various transactions that have been executed within each of the Raptor structures since their inception. The detailed description of each Raptor structure may be found in the respective memos within the 2000 audit files.

Raptor 1

- The Enron share settled put that was to terminate in October 2000, was settled early on August 3, 2000, for a payment of $3.9 million (settled by an increase in the note receivable from Talon) by Talon to Enron based on the value of the unearned premium originally paid to Talon. Because the SPE, Talon, included the maximum exposure under the put in its 3% capital requirement test, the termination of this put created excess equity capital in the vehicle of approximately $412 million that can be utilized to execute derivative transactions. As a result of the early termination, the manager of Talon declared a distribution in the amount of $41 million in cash to be made by Talon to the LJMII member. This distribution was made in accordance with Section 5.1 of the Amended and Restated Limited Liability Company Agreement of Talon LLC, and satisfied the required return on the equity capital.

- On August 3, 2000, Talon sold a put option to Enron for a $36 million premium whereby Enron has the right to put certain of its equity investment price risks (related to those previously sold in the Merlin CLO Trust structure) to Talon up to $93 million (maximum payout). This put requires for payouts by Talon upon certain default events related to these investments. The maximum notional amount of this derivative reduced the available capacity of the entity by approximately $93 million, which represents the maximum payout by Talon under this put option.

- Equity price swaps and option transactions of approximately $730 million in notional value were executed to hedge the exposure of fair value investments of Enron North America and Enron Broadband Services. (See memo with details in the 3rd quarter ENA file.) Capacity is available as a result of the early termination of the share settled put option between Enron and Talon, as described above, to support these instruments.

- On October 30, 2000, an equity collar transaction was executed on the 7,615,930 shares of Enron common stock in the vehicle at a floor price of $81 and a cap price of $116.12. This collar locks in the value of the Enron common stock between this floor and cap, therefore limiting Talon's exposure to the volatility of the Enron stock. Enron's credit capacity test should reflect this transaction in assessing the value of Talon's assets.

Raptor 2

- The Enron share settled put that was to terminate in December 2000, was settled early on September 22, 2000, for a payment of $6.7 million by Timberwolf to Enron based on the value of the unearned premium originally paid to Timberwolf. Enron allowed Timberwolf to satisfy this payment obligation by increasing the payable amount of the note receivable from Timberwolf. Because the SPE, Timberwolf, included the maximum exposure under the put in its 3% capital requirement test, the termination of this put created excess equity capital in the vehicle of approximately $427 million that can be utilized to execute additional derivative transactions. As a result of the early termination, the manager of Timberwolf declared a distribution in the amount of $41 million in cash to be made by Timberwolf to the LJMII member. The distribution was made in accordance with Section 5.1 of the Amended and Restated Limited Liability Company Agreement of Timberwolf LLC, and satisfied the required return on the equity capital.

- On September 22, 2000, an equity swap transaction with a $460 million notional amount was executed to hedge Enron's exposure of three international investments that are accounted for under the equity method. These equity interests are in international local distribution companies that Enron management expects to sell to third parties. The notional amount of the derivatives closely approximates Enron's book value in these assets. As of September 30, 2000 and December 30, 2000, the equity swap derivative had a fair value of 0. To support these values at each quarter end, Enron obtained an independent fair value from CSFB that supports the total fair value and restriction discount that should be allocated due to the restrictive nature of these assets.

- On November 27, 2000, an equity collar transaction was executed on the 7,809,790 shares of Enron common stock in the vehicle at a floor price of $78.875 and a cap price of $111.8633. This collar locks in the value of the Enron common stock between this floor and cap, therefore limiting Timberwolf's exposure to the volatility of the Enron stock. Enron's credit capacity test should reflect this transaction in assessing the value of Timberwolf's assets.

- On December 28, 2000, an equity collar and swap transaction was executed to hedge ENA's exposure to one of its merchant investments. Because the combination of the transactions netted to a maximum exposure to the vehicle of approximately $53 million, that amount reduced the available capacity.

Raptor 3

- Three swap transactions were executed on October 22, 2000, to hedge Enron's exposure in several total return swaps relating to three series of trusts (McGarrett within the Hawaii 125-0 Trust structure (see the applicable memo in the EES file for a detailed description of the transaction and related accounting issues). The total return swaps expose Enron to the volatility of approximately 90,000 warrants that are convertible into 18,000,000 shares of common stock of The New Power Company ("TNPC"). Therefore these swaps within Raptor 3 were executed to mitigate Enron's exposure to the price volatility of TNPC stock. As a result of these swaps, Porcupine is now exposed to changes in the value of TNPC shares. The initial price at the date of execution of the swaps was $10.75 per share of common stock

Raptor 4

- No transactions have been executed to date

As noted in our transaction memos, we review quarterly Enron's assessment of the adequacy of the credit capacity of each of the Raptor vehicles because Enron has various notes and derivatives with these entities. Consistent with the valuation of all notes and derivatives, the value recognized by each party is subject to the capacity of the other party to financially fulfill the obligation (i.e. creditworthiness). As a result, the creditworthiness of Raptor will be factored into the value of the derivative and in assessing the collectibility of the notes. Therefore, as Enron records an asset based on the value of the derivatives, its value may be impaired based on each entity's ability to pay.

To mitigate Enron's exposure to the potential decline in creditworthiness of each of the Raptor vehicles, Enron negotiated and executed an agreement with LJM, as equity holders in each of the Raptor vehicles, in December 2000. Under the agreement, the assets of each entity, Talon, Timberwolf, Porcupine and Bobcat, with the exception of the Promissory Note dated September 27, 2000, by Porcupine in favor of Pronghorn I LLC, were cross collateralized for the benefit of the creditors of each entity for a 45 day period. As consideration for this cross-collateral protection, Enron agreed to pay $50,000 to LJMII. Enron believed that this cross collateralization would allow them to benefit from the assets of each entity on an aggregate basis in assessing the credit capacity of the entities if the credit capacity test for any individual entity resulted in the need for an impairment at December 31, 2000. (However, since the individual entity credit capacity test did not yield the need for an impairment at year end, we agreed to revisit the appropriateness of the cross-collaterization in first quarter.)

During our deliberations on assessing the creditworthiness of the Raptor entities, we discussed with Carl Bass, Professional Standards Group, several options. Those options included (1) the cross collateralization for a 45 day period as described above, (2) cross collateralization for the entire term of these vehicles to be entered into after yearend but before the date of Enron's earnings release, and (3) conveying Enron's investment in certain Raptor entities to other Raptor entities to satisfy the credit worthiness test of an individual entity (in effect, an aggregation methodology). Carl Bass did not view Option 1 to be substantive because there was no true cross collaterization of the assets of the vehicle upon settlement only for a 45 day period. He did not view Option (3) to be substantive because the effect was to satisfy the creditworthiness of an entity that did not have credit capacity by using Enron owned assets, not the assets of that entity. Although he believed Option (2) achieved such cross collateralization upon settlement, the fact that that it would be entered into subsequent to December 31, 2000 was in fact a decision that the engagement team would have to assess with the Practice Director. We also discussed the practicality of Enron's position with Mike Odom, Practice Director, and Mike Lowther, Concurring Partner, who concurred with our conclusions that the client's position to view the assets of each entity on an aggregate basis in assessing credit capacity was acceptable given the latitude in SFAS 114.

Memo

ANDERSEN

Tel
Fax

To	The Files
From	Dave Duncan Debra A. Cash Patricia S. Grutzmacher Jennifer Stevenson
Date	May 9, 2001
Subject	Raptor Transaction Update

Transaction Structure

During the first quarter, Enron executed various transactions with Timberwolf and Bobcat, two entities that are primarily capitalized by related parties, (the "Entities"), (see Raptor memos in the applicable quarter files for detail explanation of structures). As described in the Raptor memo, a credit capacity test is calculated each quarter to ensure that assets recorded by Enron, due from the Entities are not impaired, and are realizable.

On March 26, 2001, 7,919393 and 4,080,607 shares of Enron common stock were sold to Timberwolf and Bobcat under a forward sales agreement in return for notes receivable of approximately \$374.9 million and \$193.2 million, respectively. These shares will not be delivered to the Entities until March 2005. Until that time, the right to purchase these shares cannot be assigned, pledged, hedged or transferred in any form to any party without the consent of Enron. Because of those restrictions, the aggregate notes receivable value of approximately \$568.1 million represents the value on Enron's books at a discount of approximately 23%. The gross value of the stock under the forward sales agreement is approximately \$737.8 million (based on a \$61.48 price as of the effective date of 3/26/01) which represents the stock value included in the credit capacity test. In addition, equity collars were executed with Enron to hedge the value of the 12 million shares of Enron stock within the two Entities at a floor of \$61.48 and a cap of \$91.02.

Additionally, Enron sold a contingent issuance that gives the Entities the right to receive up to 18 million shares of Enron common stock if certain conditions are not met under the existing forwards that were executed during 2000 with Talon, Timberwolf, and Bobcat, (the "SPEs).

The following waterfall describes the payout to each SPE under the previously executed Peregrine forward based on the Enron stock price:

SPE	Contingent share issuance	Contingency share price range
Raptor I	3,876,755	$48.55 - $52.63
Raptor II	7,809,790	$52.64 - $63.36
Raptor III	6,326,045	$63.37 - $75.89

If Enron stock does not exceed a certain price level as reflected in the above table, the newly executed contingent issuance will allow the SPEs to receive the shares that are not delivered under the Peregrine forwards in March 2003. If shares are due as a result of this contingent issuance they will also be delivered in March 2003. Similar to the above described 12 million shares, the rights under these contracts as well as the shares delivered are restricted from assignment, pledge, sale, or any form of transfer to a 3rd party without the consent of Enron.

In exchange for the issuance, Enron received an aggregate notes receivable amount of approximately $259.5 million. This amount reflects the fair value of the issuance of restricted sensus based on delivery in March 2003. The fair value of the issuance was determined based on a model created by Enron's Research Group.

In accordance with SFAS No. 114, Accounting by Creditors for Impairment of a Loan, (SFAS 114), "a creditor shall measure impairment based on 1) the present value of expected future cash flows discounted at the loan's effective interest rate, 2) the loan's observable market price or 3) the fair value of the collateral if the loan is collateral dependent." We believe that because the Raptor vehicles are highly leveraged and only enter into transactions with Enron that our impairment analysis should be assessed based on the "fair value of the collateral" or the fair value of the net assets held by Raptor.

SFAS No. 114 also states that "a creditor shall measure impairment based on the fair value of the collateral when the creditor determines that foreclosure is probable." Although the company does not believe foreclosure of the Raptor entities is probable at this time, the fair value of the collateral was appropriate for the analysis.

In assessing the credit worthiness of the Raptor entities we have used the screen price of the Enron stock at the date of valuation. We believe it is appropriate to use the current quoted price of Enron stock and not the fair value of the restricted stock at the date of valuation since the restrictions contractually expire in 2005 when the notes and derivatives are settled. That is Raptor will realize the full screen price at the time that the instruments are due and payable.

Enron and its entities (Harrier, Grizzly, Pronghorn and Roadrunner) entered into an assignment agreement with the Raptor entities (Talon, Timberwolf, Porcupine, and Bobcat) that allows each Enron entity to assign their individual rights to receive distributions from their cost method investments in the respective Raptor entities to another Raptor entity, to the extent that such entities have obligations due to an Enron entity that cannot be fully paid by the Raptor entity. In conjunction with this assignment, the termination dates of the Raptor vehicles were aligned to April 18, 2005. Enron considered this assignment in their credit capacity assessment of each Raptor entity. As a result, Enron assessed credit capacity on an aggregate basis allowing for excess asset values from one Raptor entity to absorb the excess liability values of another Raptor entity. Therefore, the impact on the credit capacity test is that credit capacity is assessed at an aggregate Raptor level. Although the client did not achieve true cross-collaterization with the assignment, we believe their assessment of credit capacity on an aggregate basis considering the cross-assignment was reasonable considering the latitude allowed under SFAS 114.

Procedures

The following procedures were performed to ensure proper accounting:

- Reviewed all transaction documents noting execution and agreement with discussed transaction terms.
- Performed an extensive review of the credit capacity models that are maintained by the client to understand the impact of the above transactions on the Entities' credit capacity. After review, the overall resulting loss was approximately $36 million.
- Discussed the valuation methodology of the contingent issuance transactions with Research Group personnel.
- Reviewed Research Group documentation describing the assumptions used in modeling the contingent issuance (see attached Exhibit I).
- Assessed the reasonableness of the Research Group's valuation methodology for the contingent issuance. (See documentation of procedures done by Andersen's quantitative team @ Exhibit II.)
- Reviewed third party documentation (Deutsche Bank) describing the reasonableness of the discount factor related to the Enron stock restrictions.
- Reviewed the equity collar contracts to ensure compliance with EITF No. 00-19, "Determination of Whether Share Settlement is within the control of the Issuer for Purposes of Applying EITF Issue No. 96-13," for verification of equity transaction accounting.

Conclusion

We discussed our conclusions with Mike Odom, Practice Director, and Mike Lowther, Concurring partner who concurred. We will continue to review and assess the credit capacity of the Entities on a quarterly basis.

Memo

ANDERSEN

Tel
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To	The Files
From	Dave Duncan Debra A. Cash Patricia S. Grutzmacher Jennifer Stevenson
Date	May 9, 2001, as amended, October 12, 2001
Subject	Raptor Transaction Update

Transaction Structure

During the first quarter, Enron executed various transactions with Timberwolf and Bobcat, two entities that are primarily capitalized by related parties, (the "Entities"). (see Raptor memos in the applicable quarter files for detail explanation of structures). As described in the Raptor memo, a credit capacity test is calculated each quarter to ensure that assets recorded by Enron, due from the Entities are not impaired, and are realizable.

On March 26, 2001, 7,919393 and 4,080,607 shares of Enron common stock were sold to Timberwolf and Bobcat under a forward sales agreement in return for notes receivable of approximately $374.9 million and $193.2 million, respectively. These shares will not be delivered to the Entities until March 2005. Until that time, the right to purchase these shares cannot be assigned, pledged, hedged or transferred in any form to any party without the consent of Enron. Because of those restrictions, the aggregate notes receivable value of approximately $568.1 million represents the value on Enron's books at a discount of approximately 23%. The gross value of the stock under the forward sales agreement is approximately $737.8 million (based on a $61.48 price as of the effective date of 3/26/01) which represents the stock value included in the credit capacity test. In addition, equity collars were executed with Enron to hedge the value of the 12 million shares of Enron stock within the two Entities at a floor of $61.48 and a cap of $91.02.

Additionally, Enron sold a contingent issuance that gives the Entities the right to receive up to 18 million shares of Enron common stock if certain conditions are not met under the existing forwards that were executed during 2000 with Talon, Timberwolf, and Bobcat, (the "SPEs).

The following waterfall describes the payout to each SPE under the previously executed Peregrine forward based on the Enron stock price:

SPE	Contingent share issuance	Contingency share price range
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Raptor II	7,809,790	\$52.64 - \$63.36
Raptor III	6,326,045	\$63.37 - \$75.89

If Enron stock does not exceed a certain price level as reflected in the above table, the newly executed contingent issuance will allow the SPEs to receive the shares that are not delivered under the Peregrine forwards in March 2003. If shares are due as a result of this contingent issuance they will also be delivered in March 2003. Similar to the above described 12 million shares, the rights under these contracts as well as the shares delivered are restricted from assignment, pledge, sale, or any form of transfer to a 3rd party without the consent of Enron.

In exchange for the issuance, Enron received an aggregate notes receivable amount of approximately \$259.5 million. This amount reflects the fair value of the issuance of restricted sensus based on delivery in March 2003. The fair value of the issuance was determined based on a model created by Enron's Research Group.

In accordance with SFAS No. 114, Accounting by Creditors for Impairment of a Loan, (SFAS 114), "a creditor shall measure impairment based on 1) the present value of expected future cash flows discounted at the loan's effective interest rate, 2) the loan's observable market price or 3) the fair value of the collateral if the loan is collateral dependent." We believe that because the Raptor vehicles are highly leveraged and only enter into transactions with Enron that our impairment analysis should be assessed based on the "fair value of the collateral" or the fair value of the net assets held by Raptor.

SFAS No. 114 also states that "a creditor shall measure impairment based on the fair value of the collateral when the creditor determines that foreclosure is probable." Although the company does not believe foreclosure of the Raptor entities is probable at this time, the fair value of the collateral was appropriate for the analysis.

In assessing the credit worthiness of the Raptor entities we have used the screen price of the Enron stock at the date of valuation. We believe it is appropriate to use the current quoted price of Enron stock and not the fair value of the restricted stock at the date of valuation since the restrictions contractually expire in 2005 when the notes and derivatives are settled. That is Raptor will realize the full screen price at the time that the instruments are due and payable.

Enron and its entities (Harrier. Grizzly, Pronghorn and Roadrunner) entered into an assignment agreement with the Raptor entities (Talon. Timberwolf. Porcupine, and Bobcat) that allows each Enron entity to assign their individual rights to receive distributions from their cost method investments in the respective Raptor entities to another Raptor entity, to the extent that such entities have obligations due to an Enron entity that cannot be fully paid by the Raptor entity. In conjunction with this assignment, the termination dates of the Raptor vehicles were aligned to April 18, 2005. Enron considered this assignment in their credit capacity assessment of each Raptor entity. As a result, Enron assessed credit capacity on an aggregate basis allowing for excess asset values from one Raptor entity to absorb the excess liability values of another Raptor entity. Therefore, the impact on the credit capacity test is that credit capacity is assessed at an aggregate Raptor level. Although the client did not achieve true cross-collaterization with the assignment, we believe their assessment of credit capacity on an aggregate basis considering the cross-assignment was reasonable considering the latitude allowed under SFAS 114.

Procedures

The following procedures were performed to ensure proper accounting:

- Reviewed all transaction documents noting execution and agreement with discussed transaction terms.
- Performed an extensive review of the credit capacity models that are maintained by the client to understand the impact of the above transactions on the Entities' credit capacity. After review, the overall resulting loss was approximately $36 million.
- Discussed the valuation methodology of the contingent issuance transactions with Research Group personnel.
- Reviewed Research Group documentation describing the assumptions used in modeling the contingent issuance (see attached Exhibit I).
- Assessed the reasonableness of the Research Group's valuation methodology for the contingent issuance. (See documentation of procedures done by Andersen's quantitative team @ Exhibit II.)
- Reviewed third party documentation (Deutsche Bank) describing the reasonableness of the discount factor related to the Enron stock restrictions.
- Reviewed the equity collar contracts to ensure compliance with EITF No. 00-19, "Determination of Whether Share Settlement is within the control of the Issuer for Purposes of Applying EITF Issue No. 96-13," for verification of equity transaction accounting.

Conclusion

We discussed our conclusions with Mike Odom, Practice Director, and Mike Lowther, Concurring partner who concurred. We will continue to review and assess the credit capacity of the Entities on a quarterly basis.

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To Files
From David D. Duncan
Debra A. Cash
Date October 15, 2001
Subject Enron-Raptor Entity Note Impairment

Overall Background

The Raptor entities are a series of SPE's (LLP's in form) set up for the purpose of hedging certain merchant investments where Enron perceived it had significant exposure to volatility. In early September, 2001, Enron brought to our attention that it believed there might be a fairly significant impairment of certain notes it had with the Raptor entities. In addition, Enron informed us that they were considering approaching the Raptor counterparties to negotiate to settle out of the entities because of changes in their top management and their desire to extract themselves from various structured activity which has been perceived negatively by the analyst community. As a result of this impending and potentially significant reporting event, combined with the complexity and sensitivity of the related party disclosures associated with the Raptor transactions, we undertook to review our collective accounting advice related to these vehicles with the Professional Standards Group (PSG) and others in practice and risk management.

Reference is made to memos dated March 28, 2000 (Raptor Transaction), July 31, 2000 (Raptor II Transaction), November 9, 2000 (Raptor III Transaction), as amended, October 12, 2001, and December 27, 2000 (Raptor IV Transactions) for background on the "Raptor Entities". Reference is also made to the memos dated December 28, 2000, May 9, 2001 and August 31, 2001 for various Raptor transaction updates.

We confirmed our prior positions, as described in the memos. However, in connection with our review, the PSG reiterated to us that they did not view the use of the aggregated impairment test methodology that had been adopted by the client, and with which we had concurred, to be an acceptable impairment test methodology. The remainder of this memorandum discusses our prior and current deliberations with respect to this issue.

Background Regarding Impairment Discussions

Currently Enron has approximately $2.3 billion of notes receivable from the Raptor entities. The notes are consideration received by Enron for 1) prior sales of Enron restricted stock and stock rights and 2) the settlement of net amounts due from the Raptor entities related to various derivative instruments. The notes bear interest at 7% with interest and principal due in April 2005, when the Raptor entities are scheduled to automatically liquidate.

Enron also has approximately $500 million, $780 million and $780 million of price risk management assets related to derivatives with the Raptor entities at December 31, 2000, March 31, 2001 and June 30, 2001, respectively. The instruments meet the definition of SFAS 133 "Accounting for Derivative Instruments and Hedging Activities" and are reported on Enron's books at fair value.

In addition to the notes and derivatives, at the time of the formation of each of the Raptor vehicles, Enron purchased, for nominal consideration, a non-voting member interest in each vehicle which gave Enron the rights to any residual value available, upon liquidation of the vehicles, after achievement of a certain stated return for the outside equity investors.

Beginning in late 2000, but more precipitously in the first quarter of 2001, many of the financial instruments in the Raptor entities declined in value. In connection with our ongoing monitoring of these entities, we have had numerous discussions with management regarding how to determine when an impairment of the Raptor related derivatives and notes receivable may be appropriate.

In our analysis of the notes, we determined that they do not represent a share, participation or interest in the underlying assets of the entities. Although, the only transactions that the Raptor entities have are with Enron, and Enron can only look to the underlying assets within Raptor for credit purposes, the form of the notes are not debt securities as defined under SFAS 115, "Accounting for Certain Investments in Debt and Equity Securities." Accordingly, Enron management determined that SFAS No. 114 was the appropriate authoritative guidance for determining impairment with respect to the notes and we concurred. SFAS No. 114 states, "a loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. The term "probable" as used in SFAS No. 114, is consistent with its use in Statement 5, which defines probable as an area within a range of the likelihood that a future event or events will occur confirming the fact of loss." Probable is the area within that range where such future events are likely (vs. reasonably possible) to occur.

SFAS No. 114 goes on to state that "measuring impaired loans requires judgement and estimates... creditors should have latitude to develop measurement methods that are practical in their circumstances". "A creditor shall measure impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate, except that, as a practical expedient, a creditor may measure impairment based on a loan's observable market price, or the fair value of the collateral if the loan is collateral dependent. Regardless of the measurement method, a creditor shall measure impairment based on the fair value of the collateral when the creditor determines that foreclosure is probable".

Considering the guidance in SFAS 114, Enron proposed an approach to evaluate the collectibility of the Raptor notes using Monte Carlo and other simulation methods that would reflect Enron's view that declines in value could recover over the holding period of the notes. Enron noted that many of the financial instruments underlying the notes had exhibited, and would be expected to continue to exhibit, a high degree of volatility. Since the notes were not scheduled to be repaid for a number of years, Enron's position was that SFAS 114 gave Enron the flexibility to estimate what it thought was a likely outcome considering this time horizon.

As we considered Enron's proposed approach through the second quarter, we noted that SFAS 114 does give a creditor a choice of measurement alternatives, as described above, and does not dictate one approach over another (unless the notes are collateral dependent and it is determined that foreclosure is probable, which it was not in this situation). Accordingly, we could not disagree that SFAS 114 allowed for subjectivity with regard to expected future outcomes and that simulation methods were appropriate methods for determining the likelihood of possible future value outcomes. Notwithstanding that view, we informed Enron that our preference, as an indicator of potential impairment, would be for a more objective evaluation approach using the loans underlying collateral value with that collateral value limited to the publicly traded price of the underlying securities, where available, because:

1. We believed the publicly traded price of a security to be the best indicator of the value of that security and that such price embodies the markets broad view of all possible future events and methods of valuation;
2. We believed the publicly traded price to be the best "current information and events" as support for what Enron could expect will occur with respect to the recoverability of the notes from these vehicles; and
3. We believed that the objectivity provided by using the publicly traded price (vs. a company prepared simulation of potential future events) was important considering the structured nature of the vehicles.

An issue we considered was whether utilizing the screen price for the restricted Enron stock related instruments was appropriate (as opposed to a discounted value that might be appropriate if the current restrictions on these instruments were considered). We noted that foreclosure with respect to the notes was not indicated and that there was nothing to indicate, through the second quarter that the notes would be settled prior to their scheduled liquidation. We noted that the restrictions naturally expire at or before the scheduled liquidation and that the ultimate collateral would be unrestricted shares. We determined that it was appropriate to consider this contractual event that will occur, that is the expiration of the restrictions, in assessing the probability of collection on the notes given those facts and circumstances. We informed Enron that, if those facts and circumstances changed, whereby 1) foreclosure became imminent or 2) there was an intention to settle the Enron stock related instruments prior to the lapse of the discount and their scheduled liquidation, the impairment test should then only consider the current settlement value of the restricted securities (which we would expect would be an amount less than screen).

Considering our views, Enron proposed to limit its views of recovery to the value of the underlying collateral securities in the vehicle using current publicly trade prices, but to perform their impairment assessment on an aggregate (of all of its interests in all of the vehicles) basis, rather than on an entity-by-entity basis, beginning in the first quarter of 2001. In connection with the development of this alternative, Enron negotiated an agreement in March 2001 with the Raptor entities that 1) assigned each Enron entities' rights to receive any distributions from these instruments in any of the respective Raptor entities to other Raptor entities, to the extent such entities have obligations due to an Enron entity that cannot be fully paid by the Raptor entity, 2) restricted Enron's ability to sell any portion of its rights to interests in any Raptor entity prior to the liquidation date and 3) realigned the various liquidation dates of the Raptor entities, previously in different months and years, to all occur simultaneously (April 2005). The effect of the assignment was that Enron committed to forego its rights to its member interest in Raptor entities where such interest may have value for the benefit of other Raptor entities that could not fulfill their obligations to Enron at liquidation.

Enron's position was that, while the March 2001 agreement was not required, it would help address our concerns of subjectivity (by lending some discipline and objectivity to the overall assessment) and noted that it would never yield a result more favorable than the net amounts recoverable from the entities if all positions (that is, Enron's notes receivable from the Raptor entities, price risk management asset related to the Raptor entities, and Enron's member interests in the Raptor entities) were liquidated as scheduled (as indicated by current prices). Also, although Enron had always viewed these exposures in the aggregate from a practical standpoint, they believed that the change they implemented with the March 2001 agreement gave important legal form (in terms of the order of liquidation) to that position and lent support to their alternative approach.

As we considered the acceptability of Enron's conclusion, we made the following observations:

- SFAS 114 1) does not dictate a methodology for estimating future cash flows for purposes of determining impairment unless foreclosure is probable, 2) recognizes that expected cash flows are "usually uncertain" and that a "creditor will be required to exercise significant judgement in developing the estimates of future cash flows", and 3) states that "creditors should have latitude to develop measurement methods that are practical in the circumstances". The net result of this was our view that SFAS 114 allowed for subjectivity.

- In other areas of authoritative literature where impairment is based on fair value, we noted that the overriding concept was for declines that are "other than temporary". The AICPA Audit and Accounting Guide related to Auditing Derivative Instruments, Hedging Activities, and Investments in Securities states in part in paragraph 47... "Regardless of the valuation method used, generally accepted accounting principles might require recognizing in earnings an impairment loss for a decline in fair value that is other than temporary. Determinations of whether losses are other than temporary often involve estimating the outcome of future events. Accordingly, judgment is required in determining whether factors exist that indicate that an impairment loss has been incurred at the end of the reporting period. These judgments are based on subjective as well as objective factors, including knowledge and experience about past and current events and assumptions about future events. The following are examples of such factors that may indicate an impairment.

    - Fair value is significantly below cost and -
        - The decline is attributable to adverse conditions specifically related to the security or to specific conditions in an industry or in a geographic area.
        - The decline has existed for an extended period of time.
        - Management does not possess both the intent and the ability to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value.

    (Remainder of paragraph not included)

  We noted that, although SFAS 114 does not require a fair value approach (unless foreclosure is probable) and is therefore possibly more subjective than this concept, that considering this concept in our facts and circumstances might help us determine reasonable limits to the subjectivity we might accept. We noted that the recent declines in the value of the various underlying financial instruments which might indicate impairment had been rapid and precipitous and many of these financial instruments had demonstrated a great deal of volatility. We further noted that Enron had the ability to hold the securities (notes) for a period over which they might recover.

- The Raptor entities and related exposures are very unique and complex. As structured transactions they are very form driven. The client's view was that the form of the assignment they used in their alternate "aggregation" methodology was important. Although, we were concerned that the assignment was not substantive since it did not appear to, other than the realignment of the settlement dates, impact anyone but Enron (and we were aware that this was the view of individuals in the PSG based on prior discussions about the use of various forms of cross-collateralization considered by Enron prior to yearend), we had to acknowledge that Enron had indeed contracted with the Raptor entities to legally change the form of ultimate settlement. In addition, Enron's methodology satisfied one of our major concerns in that it institutionalized an impairment test using current market values without reliance on more subjective matters of judgement as to future performance and volatility of the underlying assets of the Raptor vehicles.

Considering all of the above factors, particularly the fact that 1) any indicated impairment, greater than that already contemplated by Enron's methodology, resulted from declines of volatile instruments which made a temporary decline position under these facts and circumstances and 2) the net result of Enron's methodology was to impair the notes in the aggregate to the extent that currently indicated recoverable values of all positions demonstrated a net economic loss during first quarter 2001, we determined Enron's methodology was reasonable. At the time this conclusion was reached, the engagement team realized that Enron had not achieved true cross-collateralization as was recommended by our PSG as early as December, 2000 to permit an aggregate test. However, we believed that the issue was an audit issue and given the latitude allowed under SFAS 114 necessitated that we discuss our conclusions with the Practice Director and Concurring Partner.

In late March 2000, we discussed our conclusions with Mike Odom, Practice Director, and Mike Lowther, Concurring Partner, who concurred.

<u>Recent Discussions</u>

In the third quarter, we began to review all of our prior conclusions and advice related to the vehicles. In connection with this review, the PSG continued to express concerns with respect to the client's use of the aggregated impairment test methodology not withstanding our other considerations. In the PSG's view, the cross assignment should not be given accounting recognition because it is an agreement between related parties that has no economic consequence to Enron or to any other entity. As such it appears to be a nonsubstantive agreement with no apparent purpose other than to achieve a financial reporting objective.

While we had believed that the approach adopted by the client was practical in the circumstances for all of the reasons previously mentioned, we 1) informed Enron management that we now viewed their use of the aggregated impairment test methodology to be incorrect and 2) began a more detailed review of the vehicles on an entity-by-entity basis to determine whether we believed an impairment would be required in any prior periods considering alternative methods.

Enron continued to believe their methodology to be reasonable. However, they also did not believe that any additional impairment would be warranted at the end of the first or second quarter if other alternative methods were considered. They again pointed out that SFAS 114 does not prescribe that a term loan is required to be marked to the current market value of the underlying collateral unless foreclosure is probable. As has been previously discussed, our reading of SFAS 114 supported this view. Enron also pointed out:

1. The investments in the Raptor vehicles have a history of high volatility and,

2. for the most part, the underlying investments in the under-water vehicles were in operating entities with prospects for recovery. Enron believed that simulation models applied to all of the underlying investments of the Raptor entities would indicate that no impairment was required at the end of any of the previous reporting periods.

Attachment I is a summary of the results of an entity-by-entity review of the Raptor vehicles. Based on that review we determined that only Raptor I, III and IV required further analysis using an alternative approach. The alternative approach, which we discussed with the PSG, was as follows:

Step 1. Quarterly, determine on an entity by entity basis, whether there is an indication of a possible impairment. An indication of a possible impairment would be if thenet fair value of all the financial instruments of an entity, using screen prices at the date of evaluation, is less than the recorded amount of the notes and price risk management assets on Enron's balance sheet with that same entity. If the fair value exceeds the note and price risk management assets balance on Enron's books, no further analysis for impairment is necessary for the period. If the total fair value of the assets is less than the notes on Enron's books with that entity, further analysis is warranted to determine if the notes have been impaired.

Step 2 (step 2 is performed only if a possible impairment is indicated by step 1) Additional analysis consists of reviewing the individual underlying financial instruments held by the entity to determine if any have been other than temporarily impaired. An other than temporary impairment would be indicated if a security's stock price has been below its original stock price (when entity acquired the stock) for more than 6 months, if a company has gone bankrupt or is having severe financial difficulties. If the securities stock price has been below its original price for more than 6 months, but there are other indicators that may lead you to believe that the security is not other than temporarily impaired, they may be considered. Examples of a few indicators, other than stock price that may be considered are declines in the general stock market or industry category relative to the company, improving operating results, positive cash flow, and that the company appears to be successfully executing it's business strategy. These indicators may lead you to believe that there is not an other than temporary impairment even through the securities stock price has been down for more than 6 months. If an other than temporary impairment is indicated, the underlying security is impaired to the then public price. If there is not an other than temporary impairment indicated, then the security can be valued using a monte carlo simulation methodology to determine, with a minimum 25% confidence level, what the security price would be upon settlement of the underlying instrument or security. Monte Carlo simulation methods are used to predict possible outcomes of security prices at some date in the future based on current security prices and past volatility given certain confidence levels. A 25% confidence level was used to demonstrate that it was possible for the security to meet or exceed the indicated outcome from the Monte Carlo simulation. An impairment would be necessary if it is probable that you will not collect. If the sum of the current market price for the other than temporarily impaired financial instruments and the Monte Carlo values for the temporarily impaired financial instruments would provide sufficient value to pay the notes to Enron at the scheduled maturity of the notes, it is not probable that the notes are impaired.

Step 3 (step 3 is performed if step 2 results in a conclusion that the notes are impaired) The notes are written down to the current screen price of the underlying financial instruments held by the specific Raptor entity.
We reviewed the client's analysis using this alternative, and concurred with the Company's conclusion that no

impairments would have needed to be recorded on the notes with Raptor entities at December 31, 2000, March 31, 2001 and June 30, 2001. See attachments I, A1, A2 and A3 that support our conclusions.

We discussed our conclusions with those listed below, who concurred.

Steve Goddard	Larry Reiger	John Stewart
Bill Swanson	John Geron	Rick Petersen
Mike Odom	Gary Goolsby	Ben Neuhausen
Mike Lowther	Rich Corgel	Amy Ripepi

Signed not issued

Memo

ANDERSEN

To Files
From David D. Duncan
Debra A. Cash
Date October 15, 2001
Subject Enron-Raptor Entity Note Impairment

Overall Background
The Raptor entities are a series of SPE's (LLP's in form) set up for the purpose of hedging certain merchant investments where Enron perceived it had significant exposure to volatility. In early September, 2001, Enron brought to our attention that it believed there might be significant impairment of certain notes it had with the Raptor entities. In addition, Enron informed us that they were considering approaching the Raptor counterparties to negotiate to settle out of the entities because of changes in their top management and their desire to extract themselves from various structured activity which has been perceived negatively by the analyst community. (On September 27, 2001, Enron terminated their arrangements with these entities.) As a result of this impending and potentially significant reporting event, combined with the complexity and sensitivity of the related party disclosures associated with the Raptor transactions, we undertook to review our collective accounting advice related to these vehicles with the Professional Standards Group (PSG) and others in practice and risk management.

Reference is made to memos dated December 31, 1999, as amended October 12, 2001, March 28, 2000, as amended October 12, 2001 (Raptor Transaction), July 28, 2000, July 31, 2000 (Raptor II Transaction), November 9, 2000 (Raptor III Transaction), as amended, October 12, 2001, and December 27, 2000 (Raptor IV Transactions). December 28, 2000, as amended, October 12, 2001, May 9, 2001, as amended. October 12, 2001, July 17, 2001, August 31, 2001 and September 1, 2001 for background on the "Raptor Entities".

In connection with our review, the PSG advised us that the use of the aggregated impairment test methodology that had been adopted by the client, was not an acceptable impairment test methodology. This advice was consistent with the PSG's views expressed in December 2000, and at that time the client adopted an approach with which the audit team concurred based on issues deemed to be audit considerations. (See Memo dated December 28, 2000, as amended October 12, 2001.) .

Enron's Impairment Methodology

On September 26, 2001, Enron had approximately $2.4 billion of net notes receivable from the Raptor entities. The notes are consideration received by Enron for 1) prior sales of Enron restricted stock and stock rights and 2) the settlement of net amounts due from the Raptor entities related to various derivative instruments. The notes bear interest at 7% with interest and principal due in April 2005, when the Raptor entities are scheduled to automatically liquidate.

Enron also had approximately $500 million, $690 million and $640 million of price risk management assets related to derivatives with the Raptor entities at December 31, 2000, March 31, 2001 and June 30, 2001, respectively. The instruments meet the definition of SFAS 133 "Accounting for Derivative Instruments and Hedging Activities" and were reported on Enron's books at fair value. These price risk management assets will be the subject of a separate memorandum.

In addition to the notes and derivatives, at the time of the formation of each of the Raptor vehicles, Enron purchased, for nominal consideration, a non-voting member interest in each vehicle which gave Enron the rights to any residual value available, upon liquidation of the vehicles, after achievement of a certain stated return for the outside equity investors.

Beginning in late 2000, and continuing more precipitously in 2001, many of the financial instruments in the Raptor entities declined in value. We had numerous discussions with management regarding how the Company determines when an impairment of the Raptor related derivatives and notes receivable had occurred.

The Company determined that the notes do not represent a share, participation or interest in the underlying assets of the entities. Although the only transactions that the Raptor entities have are with Enron, and Enron can only look to the underlying assets within Raptor for credit purposes, the form of the notes are not debt securities as defined under SFAS 115, "Accounting for Certain Investments in Debt and Equity Securities." Accordingly, with no other specific literature on point, Enron management determined that SFAS No. 114 was the appropriate authoritative guidance for determining impairment with respect to the notes and we concurred. SFAS No. 114 states, "a loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. The term "probable" as used in SFAS No. 114, is consistent with its use in Statement 5, which defines probable as an area within a range of the likelihood that a future event or events will occur confirming the fact of loss." Probable is the area within that range where such future events are likely (vs. reasonably possible) to occur. Although the notes should be displayed as an offset to equity (see September 1, 2001 memo), these notes are unlike normal subscription receivables because failure to pay would not result in return of Enron stock. Therefore, the Company concluded that any impairment on the notes should be charged to income.

SFAS No. 114 goes on to state that "measuring impaired loans requires judgement and estimates... creditors should have latitude to develop measurement methods that are practical in their circumstances". "A creditor shall measure impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate, except that, as a practical expedient, a creditor may measure impairment based on a loan's observable market price, or the fair value of the collateral if the loan is collateral dependent. Regardless of the measurement method, a creditor shall measure impairment based on the fair value of the collateral when the creditor determines that foreclosure is probable".

Considering the guidance in SFAS 114, Enron proposed an approach to evaluate the collectibility of the Raptor notes using Monte Carlo and other simulation methods that would reflect Enron's view that declines in value could recover over the holding period of the notes. Enron noted that many of the financial instruments underlying the notes had exhibited, and would be expected to continue to exhibit, a high degree of volatility. Since the notes were not scheduled to be repaid for a number of years, Enron's position was that SFAS 114 gave Enron the flexibility to estimate what it thought was a likely outcome considering this time horizon.

As we considered Enron's proposed approach through the second quarter, we noted that SFAS 114 does give a creditor a choice of measurement alternatives, as described above, and does not dictate one approach over another (unless the notes are collateral dependent and it is determined that foreclosure is probable, which it was not in this situation). SFAS 114 allows for subjectivity with regard to expected future outcomes and we could not disagree that simulation methods were appropriate methods for determining the likelihood of possible future value outcomes. We noted also that Enron uses the Monte Carlo simulation method in other aspects of its business and has substantial experience in applying this method. We informed Enron that our preference, as an indicator of potential impairment, would be a more objective evaluation approach using the loans' underlying collateral value with that collateral value limited to the publicly traded price of the underlying securities, where available.

An issue we considered was whether utilizing the screen price (publicly quoted price) for the restricted Enron stock related instruments was appropriate (as opposed to a discounted value that might be appropriate if the current restrictions on these instruments were considered). We noted that foreclosure with respect to the notes was not indicated and that there was nothing to indicate, through the second quarter, that the notes would be settled prior to their scheduled liquidation. We noted that the restrictions naturally expire at or before the scheduled liquidation and that the ultimate collateral would be unrestricted shares. We determined that it was appropriate to consider this contractual event that will occur, that is the expiration of the restrictions, in assessing the probability of collection on the notes given those facts and circumstances. We informed Enron that, if those facts and circumstances changed, whereby 1) foreclosure became imminent or 2) there was an intention to settle the Enron stock related instruments prior to the lapse of the restriction and their scheduled liquidation, the impairment test should then only consider the current settlement value of the restricted securities (which we would expect would be an amount less than screen).

Considering our views, Enron proposed to limit its views of recovery to the value of the underlying collateral securities in the vehicle using current publicly trade prices, but to perform their impairment assessment on an aggregate (of all of its interests in all of the vehicles) basis, rather than on an entity-by-entity basis, beginning in the first quarter of 2001. In connection with the development of this alternative, Enron negotiated an agreement in March 2001 with the Raptor entities that 1) assigned Enron's rights to receive any distributions from these instruments in any of the respective Raptor entities to other Raptor entities, to the extent such entities have obligations due to Enron that cannot be fully paid by the Raptor entity, 2) restricted Enron's ability to sell any portion of its rights to interests in any Raptor entity prior to the liquidation date and 3) realigned the various liquidation dates of the Raptor entities, previously in different months and years, to all occur simultaneously (April 2005). The effect of the assignment was that Enron committed to forego its rights to its member interest in Raptor entities where such interest may have value for the benefit of other Raptor entities that could not fulfill their obligations to Enron at liquidation.

Enron's position was that, while the March 2001 agreement was not required, it would help address our concerns of subjectivity (by lending some discipline and objectivity to the overall assessment) and noted that it would never yield a result more favorable than the net amounts recoverable from the entities if all positions (that is, Enron's notes receivable from the Raptor entities, price risk management asset related to the Raptor entities, and Enron's member interests in the Raptor entities) were liquidated as scheduled (as indicated by current prices). Also, although Enron had always viewed these exposures in the aggregate from a practical standpoint, they believed that the change they implemented with the March 2001 agreement gave important legal form (in terms of the order of liquidation) to that position and lent support to their approach.

As we considered the acceptability of Enron's conclusion, we made the following observations:

- SFAS 114 1) does not dictate a methodology for estimating future cash flows for purposes of determining impairment unless foreclosure is probable, 2) recognizes that expected cash flows are "usually uncertain" and that a "creditor will be required to exercise significant judgement in developing the estimates of future cash flows", and 3) states that "creditors should have latitude to develop measurement methods that are practical in the circumstances". The net result of this was our view that SFAS 114 allows for judgment and the use of different approaches.

- In other areas of authoritative literature where impairment is based on fair value, we noted that the overriding concept was for declines that are "other than temporary". The AICPA Audit and Accounting Guide related to Auditing Derivative Instruments, Hedging Activities, and Investments in Securities states in part in paragraph 47..."Regardless of the valuation method used, generally accepted accounting principles might require recognizing in earnings an impairment loss for a decline in fair value that is other than temporary. Determinations of whether losses are other than temporary often involve estimating the outcome of future events. Accordingly, judgment is required in determining whether factors exist that indicate that an impairment loss has been incurred at the end of the reporting period. These judgments are based on subjective as well as objective factors, including knowledge and experience about past and current events and assumptions about future events. The following are examples of such factors that may indicate an impairment.

    - Fair value is significantly below cost and -
        - The decline is attributable to adverse conditions specifically related to the security or to specific conditions in an industry or in a geographic area.
        - The decline has existed for an extended period of time.
        - Management does not possess both the intent and the ability to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value."

    (Remainder of paragraph not included)

  We noted that, although SFAS 114 does not require a fair value approach (unless foreclosure is probable) and is therefore possibly more subjective than this concept, that considering this concept in our facts and circumstances might help us determine reasonable limits to the subjectivity we might accept. We noted that the recent declines in the value of the various underlying financial instruments which might indicate impairment had been rapid and precipitous and many of these financial instruments had demonstrated a great deal of volatility. We further noted that Enron had the ability to hold the notes for a period over which they might recover.

- The Raptor entities and related exposures are very unique and complex. As structured transactions they are very form driven. The client's view was that the form of the assignment they used in their "aggregation" methodology was important. We were concerned that the assignment was not substantive since it did not appear to, other than the realignment of the settlement dates, impact anyone but Enron. We acknowledged, however, that Enron had indeed contracted with the Raptor entities to legally change the form of ultimate settlement. In addition, Enron's methodology institutionalized an impairment test using current market values without reliance on more subjective matters of judgment as to future performance and volatility of the underlying assets of the Raptor vehicles.

Considering all of the above factors, and that 1) any indicated impairment resulted from what management believed to be temporary declines of volatile instruments and 2) the net result of Enron's methodology was to impair the notes and price risk management assets in the aggregate to the extent that currently indicated recoverable values of all positions demonstrated a net economic loss during first quarter 2001, we determined Enron's methodology was reasonable. We believed that the issue was an audit issue and given the latitude allowed under SFAS 114 necessitated that we discuss our conclusions with the Practice Director and Concurring Partner. In late March 2001, we discussed our conclusions with Mike Odom, Practice Director, and Mike Lowther, Concurring Partner, who concurred.

Third Quarter Review

In the third quarter, the Company informed us it would be recognizing a significant impairment. In connection with our review of the Company's accounting for impairment, we consulted with the PSG, which expressed concerns with respect to the client's use of the aggregated impairment test methodology notwithstanding our other considerations. In the PSG's view, the cross assignment should not be given accounting recognition because it is an agreement between related parties that had no economic consequence to Enron or to any other entity, and the apparent purpose was to achieve a financial reporting objective.

While we had believed that the approach adopted by the client was practical in the circumstances for all of the reasons previously mentioned, we 1) informed Enron management that we now viewed their use of the aggregated impairment test methodology to be incorrect, 2) asked Enron to adopt an acceptable methodology and 3) began a more detailed review of the vehicles on an entity-by-entity basis to determine whether we believed an impairment would be required in any prior periods considering alternative methods.

Enron continued to believe their methodology to be reasonable. However, they also did not believe that any additional impairment would be warranted at the end of the first or second quarter if they assessed impairment on a disaggregated basis using screen prices and, where appropriate, Monte Carlo simulation methodologies. .They again pointed out that SFAS 114 does not prescribe that a term loan is required to be marked to the current market value of the underlying collateral unless foreclosure is probable. As has been previously discussed, our reading of SFAS 114 supported this view. Enron also pointed out:

1. The investments in the Raptor vehicles have a history of high volatility and,
2. For the most part, the underlying investments in the under-water vehicles were in operating entities with prospects for recovery. Enron believed that acceptable simulation models applied to all of the underlying investments of the Raptor entities would indicate that no impairment was required at the end of any of the previous reporting periods.

Attachment I is a summary of the results of an entity-by-entity review of the Raptor vehicles based on the analysis prepared by Enron. After reviewing Enron's analysis, we determined that Raptor I, II, III and IV required further analysis. Enron assessed the derivatives separately from the notes. Enron recorded the derivatives at fair value, considering the credit worthiness of the counterparty. (Our analysis of this approach is subject to a separate memo). Enron assessed the notes as follows:

Step 1. Quarterly, determine on an entity by entity basis, whether there is an indication of a possible impairment. An indication of a possible impairment would be if the net fair value of all the financial instruments of an entity, using screen prices at the date of evaluation, is less than the recorded amount of the notes and price risk management assets on Enron's balance sheet with that same entity. If the fair value exceeds the note and price risk management assets balance on Enron's books, no further analysis for impairment is necessary for the period. If the total fair value of the assets is less than the notes on Enron's books with that entity, further analysis is warranted to determine if the notes have been impaired. Based on this step, Raptor II required no further analysis for note impairment.

Step 2 (step 2 is performed only if a possible impairment is indicated by step 1). Statement 114 states that a loan is considered impaired when it is <u>probable</u> that a creditor will be <u>unable</u> to collect all amounts due (principal and interest) according to the contractual terms of the loan agreement. The Company concluded that it is appropriate to use a 75 percent likelihood of occurrence as being "probable." We agree that 75 percent is a reasonable percentage to use as being "probable." Accordingly, if there is at least a 25 percent chance that the principal and all future interest due under the notes will be collected when due, then it is not probable the Company will be unable to collect all amounts due; thus the notes are not impaired.

The debtors own equity securities and are party to various derivative financial instruments for which the underlyings are equity securities. Using information about an equity security's current price and its historic volatility, the likelihood of any future price being achieved can be determined for most equity securities using a Monte Carlo simulation method. As we consulted with valuation experts in our Financial and Commodity Risk Consulting Group, we determined that, Monte Carlo simulation methods may not produce the most reasonable possible outcomes for some equity securities. For example, it would not be appropriate to use Monte Carlo for companies in bankruptcy or for companies not expected to have a future stock price. It theoretically would be acceptable to use Monte Carlo for companies in severe financial difficulty. However, the alternative method described here takes a more cautious approach. If the value of an equity security has declined since the debtor acquired the equity security (or entered into the related derivative) and the value has not recovered within a six month period, that company is presumed to be in severe financial difficulty and is specifically reviewed to determine if its specific facts and circumstances can overcome the presumption that Monte Carlo would not be used. Indicators that would overcome that presumption include improving operating results, positive cash flow, and successful execution of its business strategy.

Accordingly, the equity securities (both owned and used as underlyings in derivatives) should be separated into two groups -- those equity securities for which future prices can be modeled using a Monte Carlo simulation model and those for which Monte Carlo may not produce the most reasonable outcomes. For those equity securities for which Monte Carlo simulation is not applied, current fair value of the equity security is used as the estimate of the equity security's future value.

For equity securities whereby the Monte Carlo simulation model is applied, the Company used that model to determine the lowest equity security price in a range of most favorable potential outcomes that has a 25 percent likelihood of occurring at a future specific date. For owned equity securities, that future date is the date the debtor entity is scheduled to be liquidated and the notes paid. For equity securities that are an underlying for a derivative financial instrument, that future date is the date the derivative is scheduled to settle and that future equity security price is the price used to estimate the amount of the ultimate settlement of the derivative.

If the projected resources of the debtor, using the amounts computed as described in the preceding paragraphs, are sufficient for the debtor to pay all amounts when due (principal and interest), the notes are not impaired. If the projected resources of the debtor are not sufficient, the notes are impaired.

Step 3 (step 3 is performed if step 2 results in a conclusion that the notes are impaired) Once a note is identified as being impaired under SFAS 114, the emphasis changes and requires that the lender make its best estimate of what cash flows <u>will</u> be collected. The notes are written down to the amounts recoverable from the underlying financial instruments held by the specific Raptor entity. The current screen price represents the best estimate of what will be collected.

We discussed this "three step" approach with members of the PSG (John Stewart, Rick Petersen, Ben Neuhausen, and Amy Ripepi). They concurred with our conclusion that this approach to assessing and measuring impairment of the SFAS No. 114 notes is acceptable.

We reviewed the client's analysis using this alternative, assessed management's judgements, and tested their calculations. We also reviewed information concerning significant portions of the underlying collateral to test the Company's use of the methodology described above. Based on this work, we concurred with the Company's conclusion that no impairments would have needed to be recorded on the notes with Raptor entities at December 31, 2000, March 31, 2001 and June 30, 2001. See attachments I, A1, A2 and A3 that support our conclusions.

We discussed our conclusions with those listed below, who concurred.

Steve Goddard
Bill Swanson
Mike Odom
Mike Lowther

Rich Corgel
John Geron
Gary Goolsby
Larry Rieger

Andersen
Professional Standards Group

To: Debra A. Cash@ANDERSEN WO, David B. Duncan@ANDERSEN WO, Michael C. Odom@ANDERSEN WO
cc:
Date: 09/25/2001 03:33 PM
From: John E. Stewart, Chicago 33 W. Monroe, 50 / 72335
Subject: Enron Raptor Memos

As requested, included below are my comments on the Raptor memos itemized below and attached to Dave Duncan's lotus note dated September 14, 2001. As discussed, this is the first time that I have seen these memos. My comments below are focused on, and limited to, the area that I recall being consulted on.

Enron Raptor Memos	
Memo Date	
12/31/99	Whether in connection with this transaction or not, I recall being consulted on the general issue raised in Issue 1 at some point in the process and I agree with conclusion on Issue 1. I do not recall being involved in the final resolution of the remaining issues.
03/28/00 Raptor	At some point, whether on this transaction or not, I was consulted on the general issues raised in subissues 1 and 3 of Issue 1 and Issue 6, and agree with the answers. I do not recall being involved in the final resolution of the remaining issues.
03/28/00 Redesignation	OK.
07/28/00	No mention of me.
07/31/00	No mention of me.
11/09/00	No mention of me.
12/27/00	No mention of me.
12/28/00	See Carl Bass' 09/25/01 Lotus Note.
05/09/01	No mention of me. See Carl's 09/25/01 Lotus Note.
07/17/01	No mention of me.

Interoffice Memorandum

To: Rick Causey, Wes Colwell

From: Ryan H. Siurek

Department: Transaction Support

Subject: RTHM Impairment Analysis

Date: March 2, 2000

The purpose of this memorandum is ascertain the effect of SFAS No. 114 (SFAS 114), *Accounting by Creditors for Impairment of a Loan*, and a recent DIG issue regarding collectibility of hedge gains in determining the appropriate accounting treatment of the RTHM's option basket at December 31, 1999.

Scope (Paragraphs 4-6)

SFAS 114 applies only to creditors and addresses the **recognition of impairment** and **measurement of impairment** for all loans (collateralized or uncollateralized) except for the following:

- Small balance homogenous loans
- Loans carried at fair value
- Leases
- Debt securities within the scope of SFAS No. 115, *Accounting for Certain Investment in Debt and Equity Securities*

Recognition of Impairment (Paragraphs 8-10)

SFAS 114 applies a SFAS No. 5 *Accounting for Contingencies*, approach to evaluating whether or not a loan is impaired. That is, a measurement event does not occur until a creditor determines that a loan is impaired. Recognition of impairment is determined when it is **probable** that the creditor will be unable to collect all amounts due according to the contractual terms of the agreement. The term **probable** has the same meaning in SFAS 5 and SFAS 114. SFAS 5 requires recognition of a loss when **both** (a) information available prior to the issuance of the financial statements indicates that an asset has been impaired at the date of the financial statements **and** (b) the amount of loss can be reasonably estimated (paragraph 8). The Board clarified that the term probable means a higher level of likelihood than "more likely than not." The Board also clarified that the term probable does not mean "virtually certain."

Question 9 to the FASB Staff Implementation Guidance, *Application of FASB Statements 5 and 114 to a Loan Portfolio* addresses the issue of determining the method utilized to determine collectibility and states:

> How should a creditor determine it is probable that it will be unable to collect all amounts due according to the contractual terms of a loan under Statement 114?
>
> The Board decided not to specify how a creditor should determine that it is probable that it will be unable to collect all amounts due according to a loan's contractual terms. A creditor should apply its normal loan review procedures in making that determination.

AALLP's interpretation of SFAS 114 addresses the issue of loans that do not have stated payment dates and that accrue interest at the contractual rate. This concept is similar to a financial instrument that does not settle until a future period or has the ability to settle at future dates (i.e. option contracts). Question 7 addresses this issue by stating:

> For some creditors, it is not unusual to have cash flow loans whose payments are based solely on the actual property cash flow (e.g., real estate loans). Given the lack of scheduled payment amounts, how should a creditor evaluate and measure impairment on the loan?
>
> Since most cash flow loans do not become past due prior to maturity and they continue accruing interest at the contractual rate, the loans would be treated similar to demand loans as discussed in the last

sentence of paragraph 8 For such loans, the creditor must have a process in place to determine whether it will collect all amounts due Assuming there are no concerns regarding collectibility of all principal AND INTEREST, a loan would not be classified as impaired. If a cash flow loan does become impaired, its impairment would be measured similar to all loans. The lack of an established payment schedule should not impact the measurement

Measurement

When a loan is impaired, as determined in the previous recognition section, a creditor shall measure the impairment based on one of the following methodologies:

- Present value of expected future cash flows discounted at the effective interest rate
- Loan's observable market price
- Fair value of the collateral if the loan is collateral dependant

Current DIG Issue

The DIG is currently addressing the issue of financial instrument impairment in conjunction with the highly effective criteria between the hedge underlying and the hedging instrument. The DIG has determined that

> when the derivative is in an asset position, the entity must be aware of the counterparty's creditworthiness (and changes therein) in determining the fair value of the derivative. Although a change in the counterparty's creditworthiness would not necessarily indicate that the counterparty would default on its obligations, such a change would warrant further evaluation. If the likelihood that the counterparty will not default ceases to be probable, an entity would be unable to conclude that the hedging relationship is expected to be highly effective in achieving offsetting cash flows.

Conclusion

SFAS 5, SFAS 114 and the current DIG issue all begin the impairment assessment based upon the probability of collectibility by the creditor. As such, a creditor that can objectively demonstrate the ability to recover its investment should not have a reason to measure an impairment.

CC:

To: David B. Duncan@ANDERSEN WO
CC:
BCC:
Date: 10/15/2001 04:29 PM
From: Rodney Faldyn@enron.com
Subject: FW: re: Loan impairment issues
Attachments: Loan_Impairment.doc

Dave,

I just wanted to make sure you got another chance to review our original position on credit impairment

Rodney

> -----Original Message-----
> From: Siurek, Ryan
> Sent: Monday, October 15, 2001 11:41 AM
> To: Faldyn, Rodney
> Subject: re: Loan impairment issues
>
>
> Rodney,
>
> Here is a memo that I put together back in March 2000 regarding
> impairment assessments on loan receivables Our conclusion was that
> this should be a probability based approach (ie. Monte Carlo although
> that specific appoach was not mentioned) and not a "closing price at
> the end of each measurement date" approach This memo was the based
> used by Enron to discuss impairment methodolgy with AA as it pertains
> to the Rthyms transaction, the predecessor to the Raptor transactions.
> Rick and I discussed this issue at length with Dave and Deb; however,
> their conclusion was that the probability approach was not
> approapriate for this type of a transaction Rick further discussed
> this issue with John Stewart but was unable convince him that our
> approach was appropriate I find it intriguing that we are falling
> back to a position that we were told we could not use.
>
> Feel free to forward this on to Rick as evidence of our initial
> discussions with AA.
>
> <<Loan_Impairment.doc>>
>
> Regards,
>
> Ryan

*AAHEC(2)000140.1

at enron.messaging.administration@enron.com and delete all copies of the message. This e-mail (and any attachments hereto) are not intended to be an offer (or an acceptance) and do not create or evidence a binding and enforceable contract between Enron Corp. (or any of its affiliates) and the intended recipient or any other party, and may not be relied on by anyone as the basis of a contract by estoppel or otherwise. Thank you.

 - Loan_Impairment.doc

To: David B Duncan @ ANDERSEN WO
CC:
BCC:
Date: 10/02/2001 01:45 PM
From: Don Holley
Subject: Raptor Asset Hedges
Attachments: Raptor-1-ENA-Asset-Hedges.xls

Here's the revised schedule.

Raptor 1
Losses on ENA Asset Hedges
(Losses in $000's)

		Inception	3Q00	4Q00	1Q01	2Q01	3Q01
Public:							
Avici	Share Price	163.50	95.13	24.63	8.00	8.57	1.28
	Shares (000's)		1,093	1,093	1,093	1,093	1,093
	Gain/(Loss)		(73,670)	(77,087)	(18,156)	623	(8,084)
Catalytica	Share Price	N/A	N/A	17.25	20.94	21.70	7.66
	Shares (000's)	N/A	N/A		1,340	1,340	1,340
	Gain/(Loss)		0	(93,397)	5,324	1,100	(18,773)
Active Power	Share Price	N/A	62.00	21.94	20.31	16.68	5.01
	Shares (000's)	N/A	1,276	1,276	1,021	324	324
	Gain/(Loss)		11,487	(51,135)	(810)	781	(3,784)
Private:							
Heartland	Gain/(Loss)	0	0	0	(38,532)	0	0
Venoco Convertible	Gain/(Loss)	0	0	(1,278)	(35,366)	0	(38,411)
Merlin Credit	Gain/(Loss)	0	0	0	(63,109)	(30,638)	0
Other	Gain/(Loss)	0	3,481	(22,873)	(11,159)	(13,933)	(5,392)
Total Quarterly Loss		0	(58,702)	(245,770)	(161,808)	(42,067)	(74,444)
Total Cumulative Loss			(58,702)	(304,472)	(466,280)	(508,347)	(582,791)

*AAHEC(2)000609.1

To: David B Duncan @ ANDERSEN WO David B Duncan @ ANDERSEN WO
CC:
BCC:
Date: 09/13/2001 11:31 AM
From: Rodney Faldyn @ enron.com
Subject: FW re Raptor presentation v5
Attachments: Raptor Options PresentationV5.ppt

> -----Original Message-----
> From: Siurek, Ryan
> Sent: Wednesday, September 12, 20 3:04 PM
> To: Faldyn, Rodney
> Subject: re Raptor presentation v5
>
> <<Raptor Options PresentationV5.ppt>>

- Raptor Options PresentationV5.ppt

Project Raptor

Proposed Alternatives
September 2001

Summary
(in millions)

	Current Loss			Non-P&L Equity Increase/(Decrease)		
Option	Terminal vs. LV	Credit Deficiency	Total	Current	2005	EPS Dilution
Status Quo	N/A	($273)	($273)	($827)	$1,706	82 million (78 million already included in diluted EPS)
Buyback	($431)	($273)	($704)	($1,189)	N/A	N/A
Buyback with share issuance	($431)	$273	($704)	$1,706	N/A	82 million (78 million already included in diluted EPS)

*AAHEC (2) 000454.2

Option 1 – Do Nothing

- Current P/L charge of approximately $273 million
- EPS dilution of approximately 82 million shares at current price levels
- Reduce ENE equity by approximately $1.1 billion for the current period related to P/L charge ($273 million) and equity reclassification ($827 million)
- If ENE price < $20/share
  - Approximately $124 million P/L exposure per $1 decline in ENE price
  - EPS Dilution of 124 million shares ($360 million pre-tax income per annum)

Option 2 – Terminate All Vehicles

- Current P/L charge of approximately $609-$704 million (includes $61 million LJM payout)
- EPS benefit of approximately 82 million shares ($238 million pre-tax income per annum)
- Volatility on 18 million NPW shares (reduced from 42 million shares)
- Reduces ENE equity by approximately $1.9 billion for the current period related to P/L charge ($609-$704 million) and buy back of ENE equity instruments

Option 3 – Terminate Raptor 3

- Current P/L charge of approximately $273 million (NPW=$3.81) plus LJM buyout cost if any ($0-$31 million)
- Volatility on 18MM NPW shares (reduced from 42 million shares)
- Does not provide EPS benefit
- Reduces ENE equity by approximately $1.1 billion for the current period related to P/L charge ($273 million) and equity reclassification ($827 million)
- If ENE price < $20/share
  - Approximately $124 million P/L exposure per $1 decline in ENE price
  - EPS Dilution of 124 million shares ($360 million pre-tax income per annum)

Option 4 – Terminate Selected Instruments

- Current P/L charge of approximately $325-$363 million
- EPS benefit of approximately 16 million shares ($48 million pre-tax income per annum)
- Gross reporting in Statement of Cash Flows
- Reduces ENE equity by approximately $1.1 billion for the current period related to P/L charge ($325-$363 million) and purchase of equity instruments ($827 million)
- If ENE price < $20 share:
  - Approximately $100 million P/L exposure per $1 decline in ENE price
  - EPS Dilution of 100 million shares ($290 million pre-tax income per annum)

Assumptions

- ENE stock price of $30.49 per share
- NPW stock price of $3.81 per share
- MPR as of 9/6/01
- EPS target of $2.15 for 2002
- ENE effective tax rate of 35%
- ENE terminates (a) UBS shares and the related collars and (b) approximately 3.2 million JEDI shares and the related collars